

A thematic approach to emerging market debt

In turbulent and quieter markets alike, themes can be rewarding

by SERGIO TRIGO PAZ

“Thematic investors seek to identify trends in asset prices driven by changes in fundamentals, politics or regulations.”

This is a challenging period for investors in emerging market (EM) debt, and not just because of the dramatic spring sell-off. Even before investors started unwinding positions in anticipation of higher rates in the developed world, the kinds of opportunities enjoyed by those who came early to the asset class had grown more scarce, and traditional top-down and bottom-up approaches were becoming less effective.

While traditional approaches will regain some traction as markets stabilise, investors may also want to consider a thematic approach to EM debt. Rather than simply adopt overweight or underweight positions on certain countries or instruments, thematic investors seek to identify trends in asset prices driven by changes in fundamentals, politics or regulations, or a combination of all three. These trends may be idiosyncratic and specific to a particular country or company, or they may originate in the developed world and span a number of markets and assets.

Thematic investors aren't immune to dislocations in turbulent markets. High correlations, in particular, can be a challenge. Yet by spotting and acting on trends, they may also be able to turn the turbulence to their advantage. And, given the rapid expansion of the EM debt universe in recent years – more currencies, more regulatory regimes, more issuers and more kinds of investors – there is no shortage of themes to work with, regardless of market conditions.

THEMES ARISING FROM MARKET EXPANSION

Thanks to an expanding market in recent years, it has also become easier to express a view in EM debt. Liquidity has improved steadily as the pool of assets and investors has deepened. Between 2008 and the end of 2012, market capitalisation of the main EM debt benchmarks more than doubled, from \$1.27 trillion to \$2.73 trillion (see **figure 1**). At recent values, EM local debt is the equivalent of roughly 70% of the size of the US investment grade market. The EM debt universe has also become broader, particularly in the local debt space, for investors willing to allocate to off-benchmark bonds and to currencies with various levels of liquidity and accessibility (approximately \$9 trillion in EM local bonds is not captured by benchmarks).

These markets have also become less speculative than in the past. In 2007, only around 40% of the issues in the J.P. Morgan Emerging Markets Bond Index (EMBI) were investment grade. Today, roughly 60% of the index is investment grade and a dwindling proportion is not rated (see **figure 2**). Moreover, around 90% of EM local debt is now investment grade.

Against this backdrop, many trends play out. One recent theme was derived from anticipated monetary policy divergence among G10 countries. In recent years, many investors have funded their EM local-currency-denominated debt exposure through

short positions on the US dollar, weakened by successive rounds of quantitative easing (QE). More recently, however, the prospect of a stronger dollar has forced investors to look elsewhere for their funding currencies.

The first stage of a thematic approach to capitalising on this shift would be to review macro and monetary fundamentals in relevant countries, culminating in a set of views on which currencies are likely to strengthen and which are likely to weaken. A thematic investor might then switch short dollar positions to short positions on the

currencies they expect to weaken – for example, the euro, sterling or the yen. The investor might augment this by reversing a previous short dollar position and going long on the dollar.

A further way of playing this theme would be to try to identify which EM countries are most likely to follow the Fed in tightening monetary policy. A thematic investor would buy the currencies of the countries expected to increase rates and sell the currencies of those countries expected to decrease rates or maintain low ones.



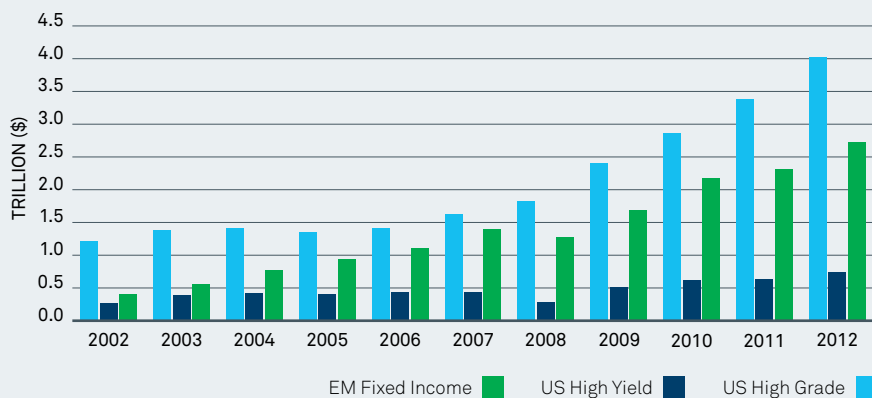
SERGIO TRIGO PAZ

Head of BlackRock's emerging markets fixed income team.

“An investable theme arose from the currency wars that developed between the US and certain EM countries.”

FIGURE 1: DEEPENING POOL

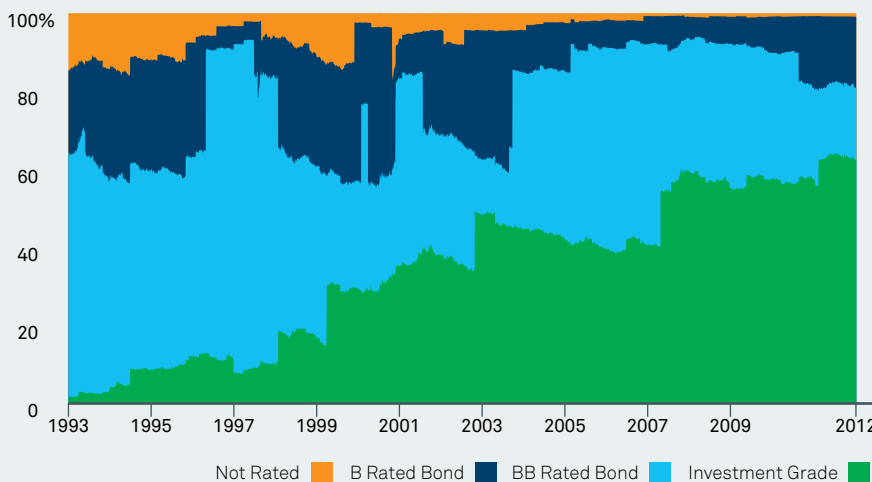
EM fixed income market cap more than doubled in four years



Source: J.P. Morgan, April 2013.

FIGURE 2: MAKING THE GRADE

Percentage of EMBI global market capitalisation by credit ratings



Source: J.P. Morgan, April 2013. Credit ratings are assigned by nationally recognised statistical rating organisations based on an assessment of the creditworthiness of the underlying bond issuers. AAA bonds carry the highest credit rating. Below investment grade is represented by a rating of BB and below. Ratings and portfolio credit quality may change over time. Unrated securities do not necessarily indicate low quality.

CURRENCY WARS, MEXICAN HOMEBUILDERS

Prior to monetary policy divergence, another investable theme arose from the currency wars that developed between the US and certain EM countries during the Fed's first two rounds of QE. The Fed's bond-buying programme led to a flood of money going from its printing presses into emerging markets, prompting fears that this would cause local currencies to appreciate, harming the competitiveness of EM countries. Some countries, most notably Brazil and Colombia, responded by competitively devaluing their own currencies; others, including Mexico and Uruguay, chose instead to allow their currencies to fluctuate.

Unfortunately for countries like Brazil and Colombia, currency wars are very difficult to win, particularly for those fighting the Fed. They generally comprise three stages: first, a country declares a currency war; second, it fights that war; and third, it loses the war and capitulates by allowing its currency to appreciate. A thematic approach to playing this theme would require adjustments at each stage. Prior to stage one, a thematic investor would adopt long positions on the Mexican peso and the Uruguayan peso, and short positions on the Brazilian real and the Colombian peso. During the second stage, the investor would reduce risk by beginning to transition out of these allocations. Finally, just before the third stage – assuming, of course, that the investor successfully anticipates this stage – they would adopt long positions on the Brazilian real and the Colombian peso before those currencies began to appreciate.

The two examples above reveal several broad, macroeconomic themes. A recent example of a more idiosyncratic, country-specific theme centres on the Mexican real estate market. When Mexico's three leading homebuilders – Desarrolladora

Homex, Corp. Geo, and Urbi Desarrollos Urbanos – decided to tap the international bond market last year, they had no trouble finding investors. However, when the new Mexican administration came to power in July 2012, it immediately formed a pact with the opposition to push for long-needed reforms to help turn around persistent low-growth levels. One major reform has been to boost infrastructure spending while redirecting subsidies away from single-family homes in commuter towns housing and towards apartments in city centres.

This has been disastrous for the three homebuilders, which had invested huge sums of money in suburban developments. It has also proved disastrous for the many investors who, based on their positive views on Mexico's prospects generally, bought the corporate bonds of these companies. A good thematic approach would have been to conduct detailed research into the likely thinking of the incoming policymakers, avoid Mexican homebuilder bonds and invest elsewhere. An alternative approach would have been to play the real estate theme via a long/short China/Mexico position, taking advantage of the then strong prospects for Chinese homebuilders.

MANAGING RISK

Thematic investing depends on good timing. The objective is to identify a theme before it becomes obvious to everybody else, and to position your portfolio accordingly. It is also vital to scale out at the right time. Achieving this requires very strong risk management: thematic investing is more difficult to manage and size than more traditional approaches, making it even more important to understand and manage the risks associated with it. Each theme has a life of its own and requires an understanding of its evolution,

performance attribution and its correlation with other themes.

To gain a sense of the risk management challenges of thematic EM debt investing, consider how the betas of EM currencies shift in various market conditions. In general, EM currencies have a long-term beta of between 0.2 and 0.5 to the market (if the market is, in this case, the S&P 500), but in periods of high risk aversion the beta of EM currencies increases dramatically. In other words, investors may become more exposed to the market at exactly the time they don't want to be, and portfolios may face sharper-than-expected losses.

This is a significant risk – it may take a year to make money from a carry trade, but only days to lose it all. To avoid this, it is important to constantly monitor foreign exchange markets for potential changes in regime. When regime changes occur, the window of opportunity for getting out of a carry trade can be very short, so the ability to act quickly is also essential.

Thematic EM debt investors need to be mindful of many such risk considerations. Scenario analysis is particularly useful in this respect, since it can help enable the investor to anticipate forthcoming global macro events that may have an impact on EM debt markets. But whatever approach is taken, rigorous, comprehensive risk management is an essential component of thematic EM debt investing.

It takes resources and prudence to pursue a thematic approach to EM debt. Such an approach, moreover, is no panacea for the recent challenges faced by EM debt investors. What it can be is a useful arrow in the quiver – an effective way of capturing alpha in markets that are sometimes volatile, sometimes quieter, but increasingly rich in both complexity and opportunity.

In Hong Kong, this information is issued by BlackRock Asset Management North Asia Limited. This material is for distribution to "Professional Investors" (as defined in the Securities and Futures Ordinance (Cap.571 of the laws of Hong Kong)) and should not be relied upon by any other persons. In Singapore, this document is issued by BlackRock (Singapore) Limited (company registration number: 200010143N) for institutional investors only. For distribution in Korea for Institutional Investors only (or "professional clients", as such term may apply in local jurisdictions). For distribution in Taiwan for Institutional Investors only. **Independently operated by BlackRock Investment Management (Taiwan) Limited.** Address: 28/F, No. 95, Tun Hwa South Road, Section 2, Taipei 106, Taiwan. Tel: (02)23261600. This document is for distribution to professional and institutional investors only and should not be relied upon by any other persons. This document is provided for informational purposes only and does not constitute a solicitation of any securities or BlackRock funds in any jurisdiction in which such solicitation is unlawful or to any person to whom it is unlawful. Moreover, it neither constitutes an offer to enter into an investment agreement with the recipient of this document nor an invitation to respond to it by making an offer to enter into an investment agreement. Past performance is not a guide to future performance. There are risks associated with investing, including loss of principal. Changes in the rates of exchange between currencies may cause the value of investments to fluctuate. This document is for informational purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock fund and has not been prepared in connection with any such offer. Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy. This document contains general information only and does not take into account an individual's circumstances and consideration should be given to talking to a financial or other professional adviser before making an investment decision. You are reminded to refer to the relevant prospectus for specific risk considerations which are available from BlackRock websites. BlackRock® is a registered trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere.

All other trademarks, servicemarks or registered trademarks are the property of their respective owners.

©2013 BlackRock Inc. All rights reserved.