

TAM goes exotic in the hunt for yield

Uncovering the opportunities in emerging market debt

Ask any investor what the major difference is between holding a company's debt and a company's equity and they will tell you bond holders are protected as, in the case of bankruptcy, it is the bond holders who get their cash back first. Given the preconception that emerging market (EM) companies are an inherently riskier alternative to their developed market peers, investors would be forgiven for believing that the debt of an EM company is a safer and thus a more palatable route into EM than buying unsecured equity. Surprise, surprise, in one of the market's typical contradictions, it's EM equities that have stolen the show from EM debt. Or have they?

Debt or equity aside, the EM trade burst onto our Bloomberg screens in early 2016 as oil prices had plummeted and China was balanced on a knife edge. The initial uptick in EM went unnoticed for a quarter as investors with the fortitude to allocate to EM amongst the melee were few and far between. Gradually, the prospects for EM growth looked more appealing, with asset allocators in 2017 now firmly banging the EM drum. Some commentators are going as far as to argue the growth metrics on a country-by-country

basis in EM are so independently strong, that lumping them all under the "EM" banner is doing each of them a disservice.

But we digress. Let's get back onto debt…

EM debt now totals some $3.5 trillion spanning both corporate and government, denominated in both local and hard currency options. It offers a particularly strong yield uptick versus developed market bonds, whilst being larger and much more diversified in terms of the types of securities on offer. In our view, the current conditions of low volatility, with moderate but broad-based global growth, provide a beneficial environment to start seeking income from what many see as riskier assets. We are currently witnessing growth with moderate inflation which is not too hot to ignite a rapid rise in interest rates, but not too cold to worry about prospects for deflation, which was the key concern in 2016. Therefore, we believe the present environment offers support to an asset class that is known to be more vulnerable to interest rate rises.

To us, the driver here seems to be the fact that markets have realised EM debt is becoming increasingly higher quality, yet still trades at a discount to its developed peers despite offering a higher yield!

EM countries have also benefited from recent weakening of the US dollar, with signs that its recent appreciation may have peaked, which could set the stage for further stabilising of EM currencies. The supply of EM debt has been rapidly rising and the fact that the consumption of these new issuances has kept pace just goes to show how confident global markets are with buying into this growth story. The weaker dollar has undoubtedly driven the strong demand for EM debt over the last 6 to 9 months, particularly local-currency debt, however pouring into the asset class purely for this reason requires an overly bearish view on the US dollar, whereas TAM believe there is much more to the story…

While the combination of increasing global growth, low interest rates and a weak dollar have certainly fuelled the surge in emerging assets this year, we believe that the fundamentals underlying EM economies point to sustained growth of the asset class. Countries such as India and Argentina have seen impressive reforms implemented over the last couple of years, consumers and corporates are beginning to deleverage and the level of earnings payed out by companies as dividends to shareholders is on the rise. This positive macroeconomic backdrop means many EM countries could now be in a position to begin easing monetary policy, which could provide a further boost to growth and help to offset the impact of any further rate rises by the Fed. All this portends to the potential for a narrowing in the risk premium over time, implying that investors into EM debt will be further rewarded for the perceived extra risk they are taking.

TAM's choice of strategy

TAM's investment philosophy is one of softly softly. You won't find our investment strategy full to the brim with exotic risk and elaborate overweights, particularly in this environment. What you will find is a combination of stable investments that we believe constitute a well-researched and conservative

approach to managing our clients' portfolios.

With EM debt covering such a broad remit of currencies, countries and industries, we favour a manager with a truly unconstrained strategy who can focus on fundamental country and credit research across the full breadth of the huge EM debt space. Our chosen manager's strategy follows a blended approach across a range of different countries, instruments and currencies, with the ability to move between each, depending on the prevailing market conditions. We believe this should enable the fund to perform well in a variety of market environments, as the blended, unconstrained strategy will react differently to changing conditions.

We are confident that, against more traditional theory, gradual monetary tightening should avoid a detrimental outcome for such riskier assets, although we are cognisant of the risk that sentiment towards the asset class could be adversely affected should the US central bank feel a faster pace of rate tightening is warranted. We have already allocated a moderate position to EM debt in models from balanced risk profiles upwards, as we are mindful not to allow our fixed income allocation to effectively become our risk-on bucket by behaving more like equities. Nonetheless, at this point in time, we believe that EM debt certainly has a place in a well-diversified portfolio and may look to increase this allocation over the remainder of the year.

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