The Global Investment Landscape: A Look at Fixed Income

Summary:

- The fixed income market landscape in emerging markets has been very strong over the last 12 months. Today, spreads are sitting at about 285 basis points.
- Significant value in global fixed income is believed to be in emerging markets. Specifically, markets like Brazil, Mexico, India, Egypt, and Peru are projected to offer very significant value.
- There is a wide variety of opportunity within the emerging market fixed income space, making it advisable for investors to work with an active manager.
- With global economies – both developed and emerging – at different economic cycles, it's crucial for investors to evaluate how these changes impact global fixed income investments.

To ensure investors are better equipped to assess risks and opportunities in the global fixed income space, the Closed-End Fund Association (CEFA) spoke with Rennie McConnochie, Head of Global Banks — Aberdeen Standard Investments, and Gary Herbert, CFA, Portfolio Manager and Head of Global Credit – Brandywine Global.


Rennie McConnochie


Gary Herbert


Libby Hastert

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on January 19, 2018.

Speaker: **Welcome and thanks for joining the Closed-End Fund Association for another discussion. Today we will hear from an industry expert who shared insight on a timely issue affecting the closed-end fund space.**

LH: **Hello, I'm Libby Hastert, Content Specialist at the Closed-End Fund Association. This morning we're speaking to Rennie McConnochie, Head of Global Banks at Aberdeen Standard Investments, and Gary Herbert, CFA, and portfolio manager and Head of Global Credit with Brandywine Global. Both Aberdeen and Brandywine offer various fixed income investments on the global frontier, making Rennie and Gary's perspectives especially interesting.**

Here in the US, we're seeing solid growth, tax reform, and the Federal Reserve appears to be on a steady path of increasing interest rates. Globally, developed markets and emerging markets may be at different points in the economic cycle. Here to discuss the markets and opportunities outside of the US are today's speakers.

Rennie, Gary, thanks for making time this morning. We'll turn things over to you. Rennie, not unlike today's discussion, we spoke with you back in June about the global landscape.

Aberdeen Standard Investments has particular expertise in emerging markets. What's the current fixed income environment across emerging markets?

RMC: Yes, thank you very much for the question and for having me on the podcast here. The fixed income market landscape in emerging markets has been very strong over the last 12 months. If you look at the hard currency market, that returned just over 10% for 2017, and local currency markets returned around 15%. There are subsets of those in terms of sovereigns, corporates, and so on and so forth, but that gives you a pretty good feel for how strong fixed income markets have been in the emerging markets area. Interesting because the year where we saw the Fed raise rates, a lot of investors have always historically been worried about EMD and EM equities for that matter underperforming in a rising-rate environment, but that's clearly not the case in 2017. There are a number of reasons for that.

Firstly, I think it's fair to say the Fed flagged its rate rises pretty clearly, so markets were prepared. The second point is that the strength of corporate and fiscal balance sheets in emerging markets in general terms, there are a number of exceptions but in general terms, remains pretty strong. The results are the possibility of hot money leaving markets on rate rises hasn't occurred. I think the environment remains a positive one. It's been a very good year, 2017, to have been exposed to emerging markets fixed income. Spreads are now sitting at about 285 basis points, so they've continued to grind in, and investors have made good money.

LH: Great. Gary, if we can go ahead and look at the opposite end of the spectrum, can you tell us about your sense of the fixed income environment in more developed markets like Europe and Japan, for instance?

GH: Thank you, Libby. Our viewpoint on the fixed income markets in developed segments like the UK, like Continental Europe and Japan, we see a high degree of overvaluation. We see stronger economies, better economic growth obviously caused by or affected by, I would argue, unorthodox monetary policy. We think some of that will be pulled away over time. Because there's stronger economic growth and modestly rising, and again I'll use the key term modestly rising, inflation expectations, we think most of those developed market yield curves offer very little value. One only needs to look at the German yield at -15 basis points or so and recognize that there's a high degree of overvaluation. Having a lot of interest rate sensitivity or exposure to what we would characterize are negative real yield sovereign bond markets in the UK, in Continental Europe, and in Japan, we think makes for a money-losing proposition. We do not favor exposures to that market and in fact believe they are very, very richly valued at this point in time.

LH: Gary, where are you currently finding value in the global fixed income market outside of Europe and Japan, and how do you factor in the currency aspect when you're identifying these opportunities?

GH: Where we see significant value in global fixed income is in fact in the emerging markets. Markets like Brazil, markets like Mexico, India, Egypt, Peru to us offer very significant value. What drives us or what helps determine value for us is real yield. That is the sovereign bond yield above forward-looking inflation expectations. When we see an attractive real yield pickup, that from our perspective, if inflation is under control or in fact even in certain cases declining, and there's better economic growth on the horizon, tends to be very attractive. What we're doing or have been doing has been making sure that our portfolio is exposed to emerging markets that offer those high real yields. Those are in the Latin American regions as well as in the Asian regions, and instead avoiding developed market bond opportunities.

Currency, the key point on this when I highlight those opportunities is from our perspective, we think the key point is to take those exposures in local currency terms. Those currency valuations in many of those markets had a severe price correction during the period of about 2013 to 2015.

From our perspective, the biggest value anomaly is actually owning those sovereign bonds in local currency terms. That offers a very significant real yield pickup, and we think and we've seen over the last year and a half or so an attractive compensation for bearing that risk in local currency terms. You'll be able to capture not only the real yield but also see currency appreciation relative to the US dollar. Owning this exposure in local currency has been very important for us.

LH: Thanks, Gary. Rennie, turning things back over to emerging markets, we often refer to them as if they're all the same, but clearly there are some important differences to make. Can you elaborate on how that is affected across country to country? Does this able an active manager to add significant value in selecting fixed income investments? Lastly, what markets are really interesting to you currently?

RMC: Just to pick up on the point that Gary was making there, and I completely agree with everything he said about the lack of value in most developed markets and the emerging market areas looking a lot more interesting, there is no doubt that one of the other factors that have been at work in the emerging markets fixed income area is this hunt for yield precisely because there is literally very little income left in terms of what's been paid out in developed markets. As Gary rightly points out, some market yields are still negative. The real returns that are being generated in a number of the EMD marketplaces really do look attractive. Yes, spreads have come in, but to Gary's point, there are still a number of markets where you are being compensated for taking risk. It's much more difficult to see that in the developed markets. I think he's absolutely correct to focus on those relative attractions in themselves.

You are right in terms of what you proposed in your question there. I think a lot of investors historically just say the term emerging markets, and it's a homogenous coverall term. In fact, underneath that you've got any number of different types of market opportunities depending on the countries you're looking at. In a number of countries you've got strong institutions, strong central banks, independent central banks where the governments don't interfere, where they're targeting inflation, and managing those exposures very well. I think if you look at the changes that have taken place, for example, in India over the last few years, the central bank has become much more independent under Rajan, and we've seen inflation targeting put in place. Even after Rajan moved on, there's a very like-minded gentleman replaced him, and the central bank is still running its inflation policy tightly. Indeed, I think the next moves in India will be a tightening of rates. That's a very good example of a market where the sovereign balance sheet has been run very well.

Then you can look at something like South Africa, which frankly has been a complete mess. You had any number of attempts to interfere with the central bank and interest rate policy, changes in the finance ministry, and Zuma definitely trying to influence what's going on within the institutions of the country. The sovereign balance sheet has just got weaker, and weaker, and weaker, and the rand has fallen precipitously, bond yields have continued to rise. Right at the end of last year after Ramaphosa won the nomination to the head of the ANC, you saw very significant rallies both in terms of bond and currency. There's an example of where politics are driving valuations. The example I mentioned before of India, valuations are being driven by economic fundamentals. Just using those two examples, you can see that there are really big differences depending on the markets you look at.
Again, if you look at other markets, Mexico, we've seen rates go up. I mentioned that India, the next move will be tightening. Indonesia, the last moves were cutting, Russia, cutting, China, very modest tightening post the latest Fed move. Different markets offer different possibilities. Some economies are run very well, others much less so. Different markets are at different stages of economic cycles. There really is a very wide variety of opportunity within the emerging market fixed income space, and therefore I think from an investor's point of view you want to work with the manager that is highly active in the space, high active market share within portfolios to take advantage of all the opportunities that are there.

Given the variety of opportunities, active management, I think, is really the only way to play this space. Indeed, if you look at passive vehicles, there's an awful lot of markets just are not included in indexes at all, and so you really do narrow your opportunity set. Yes, I think it is a market that lends itself to active management.

LH: Rennie, I think one of the things you made clear when you were talking about these emerging markets is that while yes, working with an active manager can help enhance your investments, there's always risk with all the opportunities. Gary, turning things over to you, what risk factors should investors be sensitive to, especially when they're investing in fixed income outside of the US?

GH: Sure. I think Rennie's touched on some of the points, but I would say political risk, whether it's in Mexico or South Africa, that we've seen recently, Turkey as well it's been prevalent in, that's a major element of investing in emerging markets. It's certainly been the case with Brazil, the darling of the emerging markets over the last year or so. That political risk is really something that is prevalent when investing in fixed income outside of the US. You can even argue that it's important now in investing in the US markets as well when we've got our own political issues here domestically. That's one of the factors that one needs to consider in terms of investing outside the US is the political impact that events can have on yield curves as well as currency valuations.

As well, I would say credit risk. This is a conversation that's not just focused on sovereign bonds but also corporates. Whether it's investment grade or high yield, when seeking additional yield opportunities outside the US, typically credit is a consideration. That credit or default probability risk is embedded in some of those corporate instruments whether they're investment grade, high yield, or even structured credit instruments. We look at mortgage investments, asset-backed investments globally, as well as credit investments globally. That's a key factor as well to think about when investing outside the US as well as in certain cases inside the US.

I would argue the overarching risk today is the concept of inflation risk. Whether we will, in fact, see inflation, if it does rear its head over time, that's probably a principal risk that many investors, whether they're in sovereign or credit instruments, are not necessarily well-prepared for. It's our expectation that inflation will be relatively subdued. It's not something we can neglect, but we think it's something that is unlikely to revalue portfolios negatively in the shorter term. That's another risk that one needs to consider in terms of portfolios.

Finally, because we take a lot of our exposures now, Rennie and I have both highlighted that there are opportunities in emerging markets and in local currency terms, we would argue that there's currency risk when trying to pick up these higher real yield opportunities. That's both a risk as well as an opportunity. Having a process that identifies real yield or the potential for price appreciation, these currencies vis-à-vis the dollar or another currency is really important. Those would be principle risks in portfolios, political risk, inflation risk, credit risk, and currency risk.

LH: Rennie, Gary obviously touched on inflation. In the US, Europe, and Japan, inflation has been relatively low for some time, but inflation in emerging markets can be a lot more volatile. How do you address that risk in your EM fixed income portfolios, Rennie?

RMC: We'll talk a little bit about inflation. I just want to add one more thing to Gary's very solid analysis of risks. The one other thing I think investors have to be very wise to is also liquidity risk. In an environment where you've got a number of investors who are graying their exposure to EMD because they love the asset class, and that's great, you may have other investors who are merely just hunting for yield and finding yield in a different part of the market they may not know so well.

A number of these areas, particularly when you start to see some selloffs, you suddenly find there isn't any bid for your paper. Investors have to be cognizant of liquidity risk as well as all the other points Gary very rightly made.

Yes, inflation is one of those risks. To Gary's point, in developed markets at the moment, inflation is probably very much a tail risk in most people's eyes. That may be right and may be wrong, but I haven't seen much change in the view of the lower for longer environment in terms of rates, be it the US, be it Europe, or be it Japan. As you rightly say, the emerging markets inflation picture is both different and varied. One of the other points I'd like to make is it's not necessarily inflation itself that is a risk. One should be much more focused on the direction of inflation because some of the fixed income markets with the very highest levels of inflation have provided some of the strongest returns because that inflation is coming down significantly. I'm thinking in particular over the last 12 months, even though it's got a little bit bumpier again, I'm thinking of Argentina as a good example of that.

What the market rewards is a change in the trend to a downward trend in inflation, and then you can get some very exciting returns. That very often is coupled with stronger currency as well. To Gary's point, some of the local currency returns in those environments can start to look very attractive. It's not just looking at a country and saying inflation is high. Where is inflation going? What is the central bank doing about rates? Is it hiking rates to push inflation down, and then analyzing what's happening there. Again, I touched on it before, some countries have very strong governmental and economic institutions where they run very sensible independent policy, others much less so. Again, when you're looking at inflation risk, you should be a lot more nervous of those countries where the institutions are weak. I mentioned South Africa before. I think that is a very good example. If you want to go right to the basket case end of things, looking at Venezuela, the latest data implies the Venezuelan economy imploded by over 16% last year, currency plummeting, and very, very high levels of inflation. Inflation is a risk, definitely.

I think speaking very generally, if you look at where the emerging market world is now relative to 10 or 15 years ago, in general terms economic institutions are a lot stronger. Central banks tend to be more independent. Fiscal balance sheets are stronger. Corporate balance sheets in the EM world are stronger. Again, it clearly varies from country to country, but I think the last real big crisis, particularly in Asia in the late '90s, taught a number of these countries some very strong lessons. They have been managing their economies significantly more prudently. Is inflation a bigger risk in the EM world than it is in the developed world? Absolutely, but are there countries where that risk is diminished and fiscal management is strong? Absolutely as well.

A country like India, which I touched on before, we think the Indian story is a very, very good story where you've seen inflation brought under control. You've seen all sorts of other reforms taking place within the economy. We think the Indian bond story remains a very attractive story. We've seen significant flows into a product we have in that marketplace. If you look at correlations, India really has not been correlated at all to say the US, or European cycles, or anything like that. The reform story there remains strong. I think it's a classic example of an emerging market where the economy and the interest rate cycles within that are being managed very efficiently and continuing to produce very attractive and significant real returns.

LH: **Thanks, Rennie, and thank you both. You've given investors a lot to think about today. I'd like to wrap things up by asking you each to, if you could in an elevator speech-kind-of-way, tell investors what you think the advantage is to using a closed-end fund to access global bond markets. I think that'd be great. Rennie, do you just want to give us your viewpoint?**

RMC: Yeah. I think closed-end funds are a very good way to access emerging markets in general and fixed income within emerging markets in particular. There are a number of reasons for that, and some of them I've touched on.

We talked about liquidity. One of the great assets of the closed-end fund structure is that you can't have redemptions. You don't run into liquidity issues because you have to supply investors with capital if they wish to withdraw it. Investors, as you know, buy shares in the fund, and the fund manager does not become a distressed seller of assets in an illiquid market as in when the storms roll in. For liquidity reasons, it makes sense. Again, because of the permanence of capital, the fund can be fully invested. That will maximize the return on your investment. The fund can be levered. Leverage always has to be very closely monitored, particularly in more volatile markets, but that leverage will over time allow you to increase the income returns you receive on your investment.

Then the last point I'd like to mention is that, as I said, an awful lot of the opportunities in emerging market bonds are not covered in the emerging market indices run by JP Morgan or anyone else for that matter. If you go with a passive product, you really do narrow your investment opportunity, and therefore the potential returns you can make. I really don't think a passive vehicle is appropriate here. There are a number of other areas where passive vehicles can make an awful lot of sense, but I don't believe they make sense in these markets. I think the closed-end fund really is almost an optimum structure for investors to gain exposure to these markets.

LH: Gary, is there anything you'd leave investors with?

GH: Yeah. I'd reiterate some of those points. I would basically summarize it with four key points, access to markets that may otherwise be challenging to get. Think of places like Argentina or Egypt, particularly in local currency terms. A closed-end fund can give you that access, I think, in a very efficient manner. Two, typically closed-end funds offer very high-income distributions. They typically pay out income monthly. I think that's very attractive for most investors. A dividend is set typically in a fixed-rate format. It allows the end client to plan accordingly given that they're sometimes dependent upon that income. Third, and Rennie touched on this, when there are challenges in the markets, we don't face significant redemptions. When you saw value in a particular emerging market, oftentimes you have the ability to add more exposure when those markets get on the margin cheaper, and you're not being a forced seller when there are particular redemptions from a more open-ended fund.

Then fourth, leverage. If an investor in a closed-end fund likes what that manager is doing, oftentimes managers will add leverage through either the bank loan market, the repo market, or the preferred market to enhance returns and enhance income from their strategy. I would highlight those four key points in terms of closed-end funds, particularly when trying to access global bond market opportunities.

LH: Gary, Rennie, thanks for joining today's call. I think that you've given listeners a lot to think about. I really look forward to seeing where the 2018 global fixed income market takes us.

Speaker: Thank you for joining us. We hope you will stop by again for news on this ever changing space. Until next time, connect with us on Twitter at @CEFAssociation, or by searching for the Closed-End Fund Association on LinkedIn and YouTube.

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