



## THE POWER OF RELATIVE VALUE IN EMERGING MARKETS LOCAL CURRENCY BONDS

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Actively managing currency positioning, rather than passively focusing on beta, is critical when investing in emerging markets local currency bonds.

As discussed in *Why Active Management Is Important in Emerging Markets Local Currency Bonds*, while coupons have delivered most of the returns, currency has been a major source of risk. Recent experience highlights the importance of considering these sources of risk and excess returns of a portfolio—and of isolating the individual drivers.

This can be achieved by employing a relative value currency strategy, which can help to reduce volatility and hedge against some of the larger risks, such as exposure to commodity prices.

In recent years, investors holding a passive long exposure to a basket of emerging market currencies versus a large, undiversified short position in the U.S. dollar would have lost out meaningfully, due to the stronger dollar. This illustrates the importance of actively managing currency. However, over time, the long-run strengthening trend of the U.S. dollar could come to an end, removing this headwind for emerging market currencies.

For example, if a large proportion of holdings in a portfolio is driven by the same factor, such as the price of oil, the underlying risks of the portfolio may not be properly balanced. A way for investors to achieve a proper balance of risks would be to pair long positions in emerging market currencies against short positions in other developed or emerging market currencies, thus avoiding the need to take a directional view on the U.S. dollar.

This is where relative value trades can help mitigate the currency risk. So instead of combining a long position in an emerging market currency, such as the Indian rupee, with a short position in the U.S. dollar, the long rupee position could instead be paired with the British pound, Thai bhat, or Australian dollar, among others.

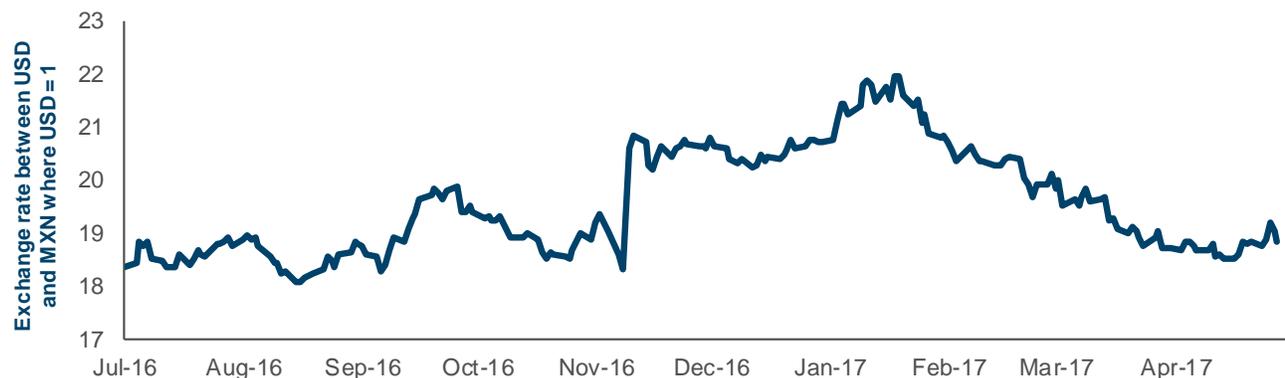
Avoiding excessive exposure to commodity prices while capitalizing on factors that are specific to a commodity-exporting country is one area where we have successfully used relative value currency positioning. For example, we expressed a favorable view on the Russian ruble by holding a long position in the ruble versus a short position in the Canadian dollar, both currencies being exposed to the price of oil. Similarly, a long position in the Brazilian real versus a short position in the Australian dollar allowed us to exploit the Brazilian currency while hedging some of the risk of the price of iron ore—a key export of both countries.

Beyond hedges on currencies exposed to commodity prices, there are other instances where relative value trades have allowed us to express views on particular emerging market currencies while mitigating risk. In 2016 after the U.S. election, the Mexican peso depreciated steeply following comments President Trump had made about the future of U.S.-Mexico relations (see Figure 1). We believed the peso had become undervalued by as much as

20% as a result, and the market momentum around the trade was favorable. However, we also wanted to hedge against the risk of a disruption to the North American Free Trade Agreement (NAFTA). This we achieved through establishing a long position in the peso versus a short position in the Canadian dollar, as both Mexico and Canada were exposed to this risk factor.

### Figure 1: Mexican Peso Weakens Following Trump Election

Mexican peso versus U.S. dollar, July 1, 2016–April 30, 2017



Source: FactSet.

Another way to implement a relative value currency trade is by taking a short position in another emerging market currency. This typically involves putting on long positions in the currencies of countries with comparatively high yields, declining inflation, and improving fundamental metrics and short positions in the currencies of countries with lower yields, rising inflation, and more challenging political situations. Examples include long positions in the Serbian dinar and Egyptian pound—both currencies of countries with slowing inflation—versus short positions in a basket of central and Eastern European currencies, where the inflation outlook is less attractive.

Similarly, relative value currency positioning can also be regional. We would take two different emerging market currencies within the same region to benefit from factors that are specific to a country while reducing regional economic and geopolitical risks. For example, in Asia, holding an overweight position in the Indonesian rupiah versus a short position in the South Korean won.

Our approach to managing emerging markets local currency debt is focused on relative value, which has allowed us to enhance our risk/return trade-off. In addition, we seek markets with the highest potential for capital appreciation and the best risk-adjusted income opportunities.

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