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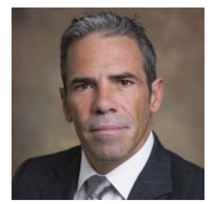
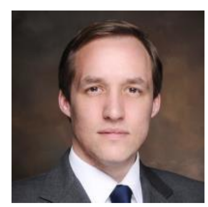
INVESTING IN TROUBLED COUNTRIES

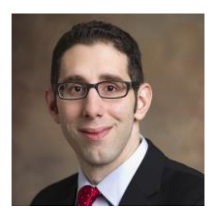
OCTOBER 2018



Michael Conelius
Portfolio Manager, Emerging Markets Bond Strategy



Andrew Keirle
Portfolio Manager, Emerging Local Markets Bond Strategy



Samy Muaddi
Portfolio Manager, Emerging Markets Corporate Bond Strategy

- Volatility in emerging markets (EMs) such as Turkey and Argentina, which rely heavily on foreign capital flows, is to be expected when global conditions shift
- There are typically three broad investment stages to a crisis: the liquidity vacuum, the transition ‘from terrible to bad’, and the return to fundamentals.
- One of the best times to be a contrarian is when market dislocations happen and managers can use their credit skills to differentiate between the casualties and the survivors.

It’s a familiar story for EM investors: shifting global conditions catch a few of the most vulnerable economies out, prompting currency crises and sharp falls in asset prices. This year Turkey and Argentina have been in the spotlight as dollar strength and buoyant US growth expectations have prompted investors to reassess the risk/return balance in EMs. Market dislocations are an important testing ground for active security security selection, with potentially outsized rewards for getting it right but high penalties for getting it wrong, So how should investors approach these (and other) troubled markets?

The local circumstances are different but the outcomes similar. Turkey’s problem was one of ‘borrowed growth’: Aggressive domestic growth policies led to surging household and corporate borrowing in recent years, largely from foreign lenders. Once international confidence evaporated, the lira plummeted, losing around a quarter of its value against the dollar in August. This pushed up import prices and forced the authorities to respond to the growing inflationary threat.

Argentina, meanwhile, was widely seen as a financial market darling whose leaders were applying orthodox economic policies to address decades of mismanagement of government finances. But rising US interest rates and some high-profile policy mistakes shattered investor confidence, and the peso’s decline accelerated sharply, prompting the central bank to raise rates to 60%.

Why did the situation in these countries unravel so fast? It's not uncommon in EM debt that, when sentiment turns, a couple of countries get disproportionately punished. This can have as much to do with liquidity as it does with fundamentals. When sentiment changes and outflows happen, the exit door is quite narrow.

For example, the 10th of August saw the Turkish lira lose as much as 23% against the US dollar in intraday trading. The Argentine peso suffered double-digit losses on the 29th and 30th before the central bank raised rates by an astonishing 15%. On those days, the currency market (typically the most liquid asset class) was essentially broken for extended periods of time. Our traders reported that brokers were unwilling or unable to quote a price in either currency against the dollar.

There were technical aspects too. For example, in the case of Argentina, because so many investors were already long, there was little room for incremental buying into the weakness.

INVESTMENT STAGES OF A CRISIS

One of the best times to be a contrarian is when market dislocations happen and active managers can use their credit skills to differentiate between the survivors and the casualties. Experience in previous EM debt crises shows that, while it can take years for a country's economic fundamentals to turn around, the recovery in asset prices tends to happen much faster: often within three to six months of a crisis. Timing, and an ability to look through the volatility and poor investor sentiment, are therefore vital. Those who have not already done their research may be forced to choose between staying on the sidelines or taking a punt on assets they don't fully understand.

There are three stages of a crisis. The first, where there is the most money to be made from yield, is where there is a severe liquidity vacuum. For example, in August, average spreads on Turkish hard currency corporate bonds blew out from under 500 basis points (b.p.) over US Treasuries to over 1200 b.p., so contrarians stood to earn a hefty yield for taking exposure to Turkish assets. The J.P. Morgan CEMBI Turkey index went on to return more than 20% between mid August and the end of September.

We had been more bearish than the market on Turkey for some time, but felt that the fundamental risks were now being priced in. By mid-August, for example, we estimated that the entire Turkish banking sector was pricing in a bankruptcy scenario, so for our corporate bond strategy we selected a couple of issuers that we had been covering on a long-term basis.

The second stage, where the greatest capital gains are to be made, is the transition 'from terrible to bad' as conditions ease, investors realise how short they are, and flows start coming back. Here, it often makes sense to retain exposure.

The third stage comes back to fundamental research and the long-term outlook for the country's assets. As the market starts chasing the rally, the time comes to decide whether to stay in or move into countries that have a more positive policy stance.

FUTURE FUNDAMENTALS

One key question is whether the currency falls in Argentina and Turkey are having a measurable impact on the economic fundamentals. In Turkey's case, we have started to see a response to the lira's weakness: tighter credit conditions and slowing growth in external debt. There is still a lot of policy adjustment needed, but the rate of deterioration is slowing. In Argentina the situation is still challenging as local investors, in particular, remain cautious.

The global conditions that underlie Turkey and Argentina's difficulties are unusual – it is rare to see expectations for higher interest rates and strong economic growth in the US simultaneously. History suggests that either US growth expectations will moderate or its strength will galvanise the global economy to catch up. But while these unusual conditions in the US persist, they are forcing uncomfortable but necessary changes on emerging economies around the world that should, in the long run, help to make them more resilient.

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