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THE IMPORTANCE OF BEING LOCAL

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In-depth knowledge can go a long way when investing in local debt markets, particularly those of smaller and less developed countries. Taking the trouble to gain a deep understanding of a country's economic prospects, politics, and policymaking can open up attractive investment opportunities that others miss or avoid because they don't have the resources to analyze the market properly.

For example, we have held a long position in Serbian local government debt since 2014. Serbia is one of a number of central and Eastern European (CEE) countries with small, well-diversified economies that are highly correlated to European Union (EU) business and monetary cycles. Some of these countries are at an advanced stage of development—the Czech Republic, Slovakia, and Slovenia, for example, are close to Western European levels of income and inflation and accordingly offer relatively low-yielding sovereign debt.

Other CEE countries—including Serbia—are less developed and historically have had higher rates of inflation, but are gradually undergoing transitions toward Western European-style institutions. When we first began purchasing Serbian government debt in 2014, its short-term bonds were yielding around 12%, significantly higher than any other country in the region. Inflation had recently collapsed from double-digit rates, but doubts over how long this would last prevented yields from falling accordingly. Further upward pressure on yields came from concerns about Serbia's large budget deficit and uncertainty over its commitment to political reform.

However, following extensive on-the-ground research, including many meetings with members of the Serbian government, the local business community, the EU, and the International Monetary Fund, we determined that the country's growth outlook was strong. In addition, we concluded that the fiscal adjustment underway in Serbia would eventually lead to a reversal in negative debt dynamics and lower financing needs and that inflation would remain low. Given all this, we concluded that the yields on government bonds were much too high and decided to invest in them.

It wasn't the first time we had made such a move. In 2012, we invested in Romanian bonds. At that time, inflation in Romania was relatively high and its debt was trading at relatively high yields (around 6.5% for the 10-year bond compared with 3.5% for Poland) as the country was still recovering from the effects of the global financial crisis in 2008–2009 and the eurozone sovereign crisis in 2011. However, we believed that Romania's economy was, in fact, broadly stable and the inflation gap was likely to decline, which would allow the central bank to cut interest rates. The debt therefore offered us a good investment opportunity, so we bought it.

Since our investments in Romania and Serbia, the yields of both countries' bonds had fallen considerably and the two positions delivered strong returns. We have mostly closed our position in Romania but remain invested in Serbia, whose 10-year debt is still attractive on a relative value basis at around 5% while inflation has been under

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2% so far this year. We believe Serbian debt can tighten a further 50–70 basis points, which may take around another year.

After that, there may be further opportunities. Some of these may be in countries that offer sizable bond markets but also relatively high risk, such as Kazakhstan and Ukraine; others may be in lower-risk countries with much smaller—and therefore difficult to invest in—bond markets, such as Georgia and Armenia. We monitor these and other countries closely through regular meetings with governments, central banks, international organizations, and businesses. As our allocations to Romania and Serbia have shown, deep local knowledge is an invaluable tool when investing in the debt markets of smaller, less developed countries.

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