Treating all EM bonds the same is completely irrational

Old habits die hard, as the adage goes. So it is with emerging market bonds at the moment. Investors have reverted to type, and sold emerging market assets without distinguishing between their vast differences.

Concerns around Chinese economic growth have sent shivers down the spines of global investors, causing severe volatility and outflows across Asia, emerging markets and even developed markets.

Yet much of what is going on doesn't make a great deal of sense when you analyse it closely.

For example, investors already knew, and importantly had priced in, that the Federal Reserve was preparing for lift-off. China's antics therefore only served to make a fragile situation worse. But let's not forget that the unreliability of China's growth rate has been a very poorly kept secret. Nobody really believed the 7% number. Unfortunately though, as is so often the case, the market appears to have overreacted. We now have to wait for it to come back into balance.

Also overblown are talks of a currency war. The devaluation of the yuan is merely a way of China contending a loss of competitiveness, while at the same time liberalising and internationalising the renminbi.

And to throw fuel on the fire, the commodities rout is now being linked to China's slowdown. Again, this is slightly naive as it doesn't reflect what is actually happening – the oil price has long had its issues. Contrary to the doom-mongers' view, there are tentative signs that demand for commodities is actually picking up and China has maintained a stable level of oil imports. The black gold's doldrums is quite plainly an over-supply story.

But here's the real point: emerging markets are not homogeneous. However, you wouldn't know it from judging investors' behaviour over the last few weeks and even months.

Such behaviour is frustrating on one level because investors, like us, who focus on the long term and in particular the underlying characteristics of each country and company's bonds inevitably feel pain while the market gyrates at the whims of flighty investors. Yet on another level, it's exciting. It may sound a bit crass, but there really are opportunities in times of stress. With patience and care, attractive bonds that have been mis-priced (over-sold) can be uncovered.

The most obvious example of this is the assumption that all emerging markets export commodities. In fact, a number of emerging economies are net oil importers, and stand to gain significantly from net-wealth effects. But another is that they all suffer from fiscal deficits and therefore financing gaps. Perversely, there's actually a benefit to soft emerging market growth resulting from a slowing China, however. Slowing growth is a blunt, but effective instrument for correcting current account deficits. The likes of India, Indonesia and Chile have already undergone this process.

To elaborate on the India story a little: it's a net oil importer and, unlike many emerging markets, it is a reform-orientated country. Prime Minister Modi has a tough job ahead, granted – but he's making good, steady progress. Further, his right hand man, Central Bank Governor Rajan, is a credible economic partner and with inflation undershooting currently, the pressure on an interest rate cut is mounting. This would provide a supportive environment for Indian government bonds in a market where the supply and demand dynamics are clean because of the relatively closed nature of the market.

None of this narrative is intended to ignore the challenges, however. Currency markets have been the most volatile and unpredictable part of the emerging bond market. Making currency calls in this environment has been extremely difficult, but as the market stabilises things should get a little easier.

In terms of major risks, investors are right to fear an aggressive Federal Reserve. Should the lift-off path be faster and steeper than investors expect markets could well be wrong-footed – and, somewhat ironically, events in China of late have only served to reduce this risk for now.

Investor sentiment is notoriously erratic. The trick in times of such uncertainty is to stay calm and look for the positives that will inevitably arise.

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MLD Ref: 22106-040915-2