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INVESTMENT NOTE

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Hermes: EM debt remains compelling

Within global high yield, emerging market (EM) debt has been the trade of the year. After outperforming developed market (DM) high yield by about 260 basis points year-to-date, one might think it is time to take profit – but Jon Brager, Senior Credit Analyst at Hermes, believes the sector will continue to shine.

The outperformance of EM high yield is remarkable when you consider the macroeconomic backdrop under which it has occurred. Most emerging economies are experiencing a slowdown in growth and struggling with heightened volatility in FX rates and capital flows. There have also been several elections and geopolitical events, which typically raise risk premiums. Meanwhile, growth is improving in the developed world and central banks remain accommodative – particularly the ECB.

Given all this, one would think DM would have been the better bet this year. But fundamentals alone do not reveal the complete picture; valuations must also be considered. Looking back 12 months from February this year, EM debt had returned only 0.5%, to 9.2% for DM. The ratio of EM credit spreads to DM credit spreads at 1.84 suggested, on a relative basis, EM had not been this cheap since the time of the Argentina default in 2002 or the dual crises in Russia and Asia in 1998/1999. Put simply, selling pressure from investors pushed EM spreads too far.

Although EM spreads have shifted significantly tighter since February, the move has not been in unison on a regional basis. LatAm corporate credit initiated the rally and spreads have essentially moved one-way tighter since. EMEA, which includes Russia, significantly underperformed as the crisis in Ukraine intensified – but spreads have recovered and are now at year-to-date tight. Asian spreads have moved tighter only recently, as concerns over Chinese growth appear to have ebbed in recent weeks. Overall, EM high yield spreads are more than 100bps tighter year-to-date, compared to about 10bp for DM. The ratio of EM to DM spreads has compressed to 1.57 – from 1.63 at the start of the year and 1.84 in late February.

Plenty of room to run for EM credit

The spread ratio between EM and DM has historically averaged around 1.2, outside of crisis periods. While we do not expect a return to this 'normal' level, given the less favourable macro outlook and uncertainty regarding the impact of Fed policy on EM rates and balances, we do think there is scope for further relative tightening to the 1.3-1.4 area. This belief is based on three main themes.

Firstly, the global reach for yield is not over, and the pickup in yield for many names in EM remains compelling. At the beginning of the year there was an overwhelming consensus DM rates were moving higher, but sure enough, rates did exactly the opposite. The yield on the 10-year treasury has moved 50bps tighter. EM credit will remain attractive for as long as DM credit sits at record tight valuations.

Secondly, many EM issuers are global enterprises, with geographically diversified exposures. These names trade at a discount to peers simply due to the EM domicile. While we do believe some discount is warranted, in many cases it appears too punitive. Within the EM space, these are our preferred credits.

Lastly, we believe many EM credits have the capacity to improve credit profiles despite the less favourable macro backdrop. The silver lining of a poor operating environment is that companies become defensive and tend to pursue strategies generally positive for credit fundamentals. Such pursuits include – refraining from large and risky acquisitions, preserving cash on balance sheet, cutting capex and opex, paying down debt, and potentially even raising capital through rights issues or issuing equity-linked instruments. There are two good examples of this – European financials and the mining sector.

Scope for improving credit quality

Until recently, the European economy was mired in a balance sheet recession and the operating environment for banks was anything but favourable. Investors had serious questions about the quality of bank balance sheets, and the link with over-indebted sovereigns. The lingering doubt pushed the credit spreads of banks to over 2.5 times as wide as non-financial spreads in late 2011. But spreads have since moved relentlessly tighter, to the point now they are nearly flat to non-financials. A large part of this outperformance has been driven by self-help moves – such as capital raises, liability management exercises, and asset disposals. These moves have improved capital ratios for banks, and by extension, credit profiles.

Likewise for miners, commodity prices have broadly declined over the past two years, which has put pressure on the earnings of the major mining companies – such as Rio Tinto, Anglo American and Glencore. These companies have responded to an otherwise bearish operating environment by slashing capex plans, cutting costs, disposing of non-core assets and protecting credit ratings. As a result, credit metrics at most miners have improved since 2013, with spreads in the sector broadly tighter.

Selection vital in next phase of rally

Despite the year-to-date outperformance, we still believe EM debt has scope to outperform DM in the second half of 2014 and perhaps even further out. Having said this, we are not simply buying EM beta. Rather, we are focusing on higher-rated EM issuers, those with global footprints. These credits preferably have dollarized revenues, but local currency costs, hedging them against local currency weakness.

As always, security selection – bond, CDS, loan, convert – also figures prominently in our investment decision. After all, one needs to get the security right, just as much as the issuer, to deliver outperformance in a value-constrained market.

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Notes to Editors:

Hermes Fund Managers

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- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and,

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- **Innovation:** We have the entrepreneurial culture to identify forward-looking products that meet those needs, along with the resources and speed-to-market mentality to develop them rapidly.

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- **Real Estate:** Segregated, Unitised, Debt, UK, US Residential, European

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