Man | GLG

MORE VOL THAN SUMMER LULL: IT'S NOT YET TIME TO DIP THE TOES BACK INTO EM WATERS

By Phil Yuhn

For institutional investor, qualified investor and investment professional use only. Not for retail public distribution.

June 2018

INTRODUCTION

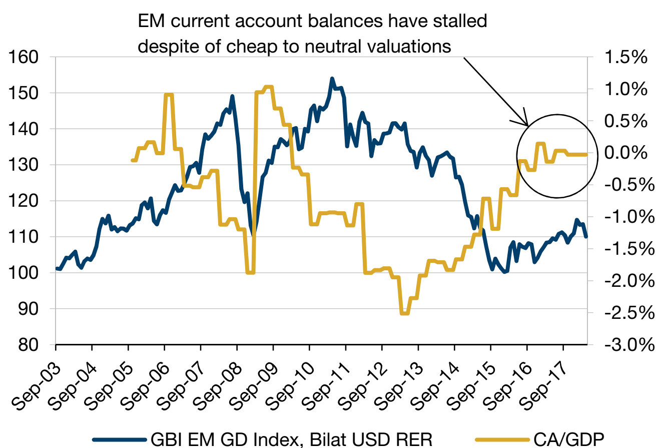
With Emerging Markets debt in the depth of a selloff not seen in quite some time, investors are left pondering whether this is a buying opportunity or if there is more room to go. In this note, we make the argument as to why we believe there will be further pain in our markets and explain the three key reasons for this view, namely: valuations, fundamentals, and positioning.

IS IT SAFE TO JUMP BACK IN?

In our write-up back in February titled 'Brace for Impact', we argued against the market consensus view that EM fundamentals and debt instruments remained attractive. We showed that the current account balances for countries comprising the EM local bond index (JPM GBI-EM GD - shown in the yellow line of Figure 1) had plateaued over the last two years (and in some countries have started to roll over) in spite of what appeared to be relatively cheap valuation of EM currencies (dark blue line line in Figure 1).

Since then, EM currencies have weakened versus the US Dollar and EM credit spreads have widened. The FX component of the local bond index has depreciated by -8.1% since its peak in late January through the end of May, while the EM hard currency index (JPM EMBIG) has seen spreads widen by +47bp year-to-date through May. The question on many investors' minds is whether this is a buying opportunity or whether there is room for further weakness in EM. Our view is firmly in the latter camp.

Figure 1. Current Account / GDP and valuations for EM countries / currencies in local bond index



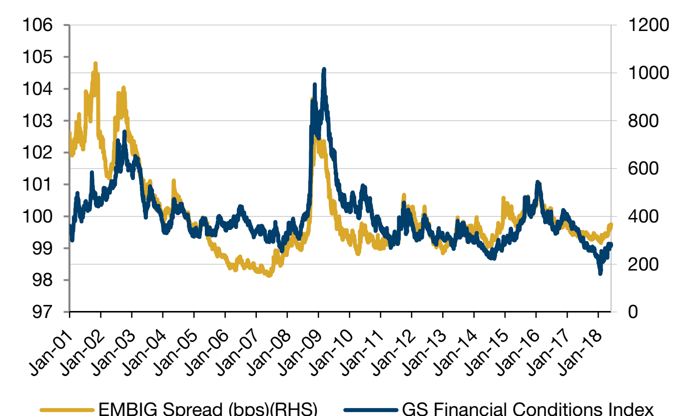
Source: Bloomberg and GLG database as of April 30, 2018.

In February, we said that we expected EM currencies to weaken as a result of the tightening of monetary conditions which had already started in the US and that we expected to see in Europe. We argued that this would lead to a slowdown, and even outflows, from the capital accounts of the EM countries. This could require many of them to return to running current account surpluses to offset capital account outflows, which in turn would require weaker real exchange rates to achieve such surpluses.

Since we published our last report, financial conditions have tightened as we expected. The blue line in Figure 2 shows the Goldman Sachs Financial Conditions Index (FCI) – a move up in the index means financial conditions are tightening, and a move down signals easing. The recent low read in the FCI in late January coincided with the peak in the GBI-EM Total Return Index – since then, financial conditions have tightened, which in turn has contributed to weakness in EM assets, particularly in the countries most sensitive to capital flows such as Argentina and Turkey. EM Hard Currency assets have sold off as well - the yellow line in Figure 2 shows the spread on the Hard Currency EMBIG Index, which you can see has been positively correlated with the moves in the FCI.

Given the importance of financial conditions to EM asset valuations, the logical question to ask is where we think it goes from here. Our view is that tightening in financial conditions has only just begun and that there is room to tighten further. We detail below the main drivers behind this assertion.

Figure 2: Goldman Sachs Financial Conditions Index vs EMBIG spreads



Source: Bloomberg as of May 31, 2018.

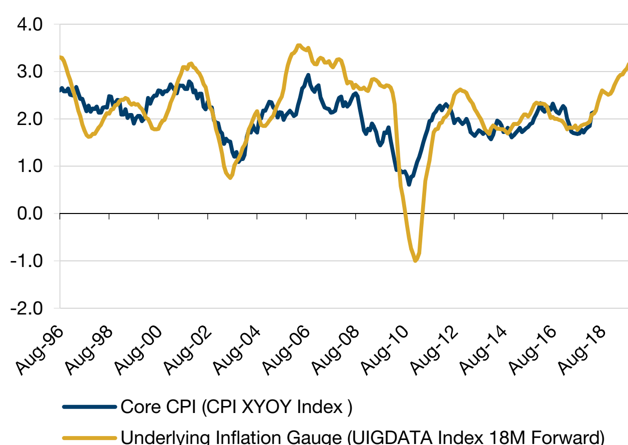
US ECONOMY TRUMPS ALL

The markets this year have faced a barrage of geopolitical risks: talk of trade wars; conflicts or tensions in the Middle East, North Korea and Iran; Italian politics and US presidential scandals. We even had the S&P 500 fall by more than 5% on two occasions within the same week after not having experienced more than a 2% drop in all of 2017. Yet, in spite of this, the UST 10YR notes continued to trudge upwards and hit a high of 3.11% (before recently falling). We believe that overriding the above-mentioned risks was the strength of the US economy and its implication for US inflation and further

monetary tightening, along with the US Treasury dynamics which we discuss in the next section.

Figure 3 below shows the lagged evolution of underlying US inflation gauge (yellow line) and US core inflation on a twelve-month rolling basis. The underlying inflation gauge (UIG) is an indicator developed by the US Federal Reserve that takes into account goods and services prices as well as other aggregates usually correlated to future inflation, such a money supply, credit spreads, and equity valuations.

Figure 3: Underlying US inflation gauge (full data set lagged 18 months) vs Core US CPI yoy



Source: Bloomberg as of May 31, 2018.

In our last publication, we showed that core inflation was running around 1.8% y-o-y at the end of December. Since then, core inflation has risen to a rate that is now closer to 2.2% y-o-y; this move up is in line with the lagged UIG. Today, the UIG index sits north of 3% p.a.; this suggests that core inflation could accelerate to that level over the next eighteen months.

To market participants who have come to accept sub-2% inflation as the new norm, sustained inflation above 2% sounds unrealistic, much less 3%. However, there are a slew of factors that we believe will continue to put upward pressure on US inflation: (i) US unemployment level at 3.9%[1]; (ii) underemployment at levels close to or below the bottom in the two previous cycles; (iii) job openings (as measured by the JOLTS index) at all-time highs and the ratio of job seekers to job openings at all-time lows; and (iv) the US economy expected to grow above its potential for the next year or two on the back of the 2017 Tax Reform bill and additional spending bill passed in 2018.

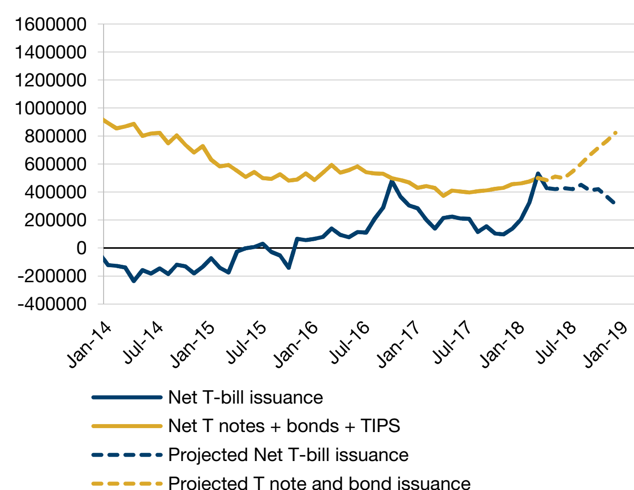
UST ISSUANCE: YOU AIN'T SEEN NOTHING YET

We think the impact of inflation and employment trends on US monetary conditions will be further complicated by Treasury issuance dynamics. As shown in Figure 4 by the blue line, the net issuance of US T-bills since November 2017 has exceeded $400bn. While significant in size, this issuance has not added much duration (DV01) into the markets due to its short maturity profile. Yet it has been one of the main drivers of UST 10YR yields exceeding the 3% threshold.

The US Treasury will continue to issue throughout the year to fund the expected increase in the fiscal deficit stemming from the Dec 2017 Tax Reform bill. Because it front-loaded its issuance calendar with T-bills, issuance for the remainder of the year will be dominated by longer-maturity notes and bonds as shown by the yellow line in Figure 4. While the projected $300bn in net notes/bonds issuance for the remainder of the year will be less than the T-bill issuance YTD, the magnitude in DV01 terms will be 10-12 times higher.

The potential for another risk-off episode (such as a deterioration in the political situation in Italy) combined with the current large short speculative positioning in UST 10yr bonds may lead to a near-term drop in Treasury yields; that aside, the medium-term outlook appears more bearish for US rates given the supply dynamics described above which could put further pressure on EM debt assets.

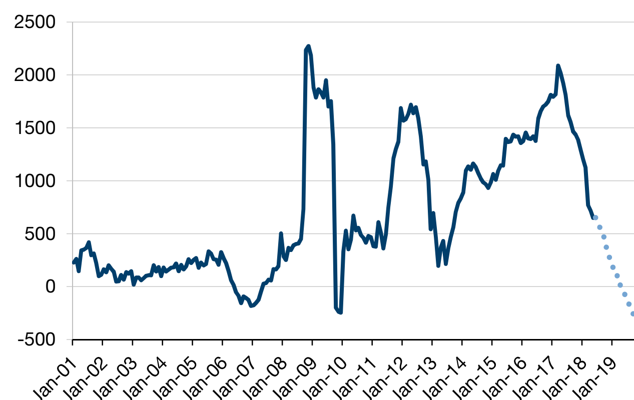
Figure 4: US Treasury debt issuance patterns



Source: Bloomberg as of May 31, 2018.

Another element which we think has (and will continue to) produce a large change in the demand for risk assets is the evolution of balance sheet positioning by the three largest developed market central banks. Figure 5 shows that the Fed, ECB, and BOJ balance sheets could go from an expansion of approximately USD2 trillion in 2017, to just USD126bn in 2018, followed by an outright contraction in 2019. The main driver of this would be the combination of the Fed's balance sheet contraction, with the ECB ending its bond buying program (the ECB will reduce the pace of purchases in October and halt it completely by end of December), If the ECB gets out of the picture, new marginal capital flows could start to gravitate back to high-quality European government bond curves, and stop going into substitute asset classes, thereby potentially increasing the pressure on risk assets such as EM debt.

Figure 5. Rolling 1-yr change of FED/ECB/BOJ balance sheets in USD



Source: Bloomberg and JP Morgan as of May 31, 2018.

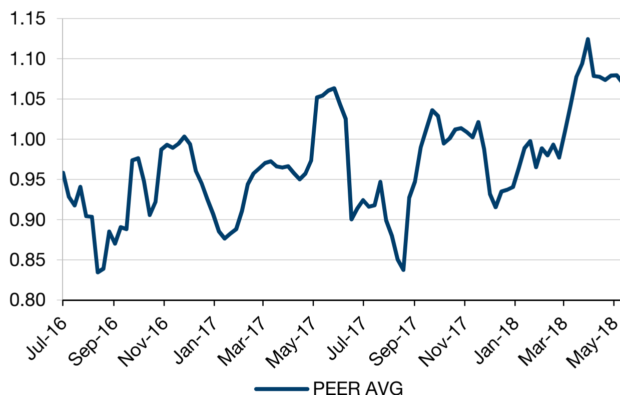
1. Source: Haver Analytics.

WHAT, ME WORRY? STAY LONG AND CARRY ON

We look at positioning, along with fundamentals and valuation, in determining our outlook on the markets. While the fundamentals mentioned above strongly suggest implementing a more defensive tilt to our portfolio, cleaner positioning would at least give us some food for thought in adjusting this view. However, we have not seen much reduction in the crowded positioning from earlier this year, and in some cases we have actually seen an increase in the taking on of risk assets.

Figure 6 shows the average rolling six-week beta of the eleven largest EM Local Bond fund managers relative to their respective benchmarks. The beta of these managers peaked at a two-year high of 1.12 prior to the start of the sell-off and it hasn't come down materially since.

Figure 6. Rolling six-week beta of 11 largest EM Local fund managers



Source: Man GLG, Bloomberg as of May 31, 2018.

Figure 7 shows the output from a multi-variate regression of the daily six-week returns of the eleven largest EM Hard Currency fund managers relative to a set of variables that are highly explanatory of returns (the R-squared of the hard currency benchmark is 0.99). When looking at the difference in the average coefficient of fund manager returns versus the coefficient of benchmark returns, one sees that the largest overweights run by these fund managers are in the riskiest parts of the asset class (Frontier Markets and EM High Yield corporates) and that this also hasn't changed matierally over the last several weeks.

Figure 7. Rolling six-week beta of 11 largest EM Hard Currency fund managers

	5/30/18	5/23/18	5/16/18	5/9/18
AVG FUND COEFF				
BELLWETHER (1)	0.33	0.31	0.32	0.40
FRONTIER MKTS (2)	0.54	0.49	0.53	0.49
VENEZUELA (3)	0.03	0.04	0.02	0.03
CEMBI HY (4)	0.17	0.33	0.39	0.22
HIGH-CARRY FX (5)	-0.09	-0.10	-0.13	-0.07
INTERCEPT				
R-SQ				
BENCHMARK COEFF				
BELLWETHER (1)	0.61	0.64	0.61	0.62
FRONTIER MKTS (2)	0.29	0.31	0.30	0.31
VENEZUELA (3)	0.02	0.01	0.02	0.02
CEMBI HY (4)	0.07	0.00	0.03	-0.01
HIGH-CARRY FX (5)	0.00	0.00	0.00	0.00
Total fund beta to (2) + (4)	0.71	0.83	0.92	0.71
Benchmark beta to (2) + (4)	0.36	0.31	0.33	0.30
Overlay beta to (2) + (4)	0.35	0.52	0.59	0.40

Source: Man GLG, Bloomberg as of May 31, 2018.

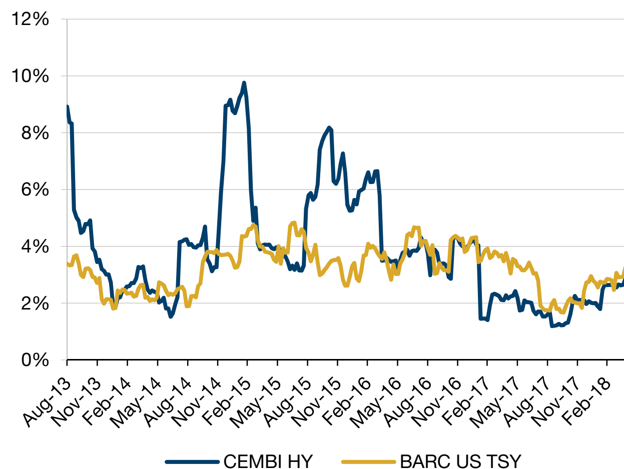
We believe the overweight in Frontier Markets is particularly worrisome as they share characteristics that leave them most vulnerable to external shocks such as tighter financial conditions: current account deficits, fiscal deficits, low FX reserves and pegged currencies (which won't give them the flexible mechanism needed to alleviate these external pressures which a floating currency would otherwise allow).

We have seen abnormally low volatility in most risk assets over the last several years, and in particular last year, as quantitative easing has dampened volatility. However, this year volatility has spiked higher in asset classes such as the S&P500 (where annualized three-month volatility has gone from 4.9% at the beginning of the year to 13.1% at the end of May) due to the aforementioned slowdown in the expansion of the three major CB balance sheets.

After an initial lag, the major EMD indices have also started to see an uptick in volatility, albeit lower in magnitude than the S&P500, with the annualized three-month rolling volatility of the EM local index going from 6.2% to 8.9% since the beginning of the year. The exception has been EM HY corporates – in Figure 8, you see that its three-month rolling volatility has barely moved since the beginning of the year and is well below US Treasury volatility.

This low volatility has been a large part of the appeal to investors who are long EM HY corporates (i.e. the carry trade). However, we expect that volatility will start catching up with other risk assets as flows have begun to reverse. When this happens, the rise in volatility could be sharp as the illiquidity that worked in its favour when flows were coming in will work the other way when flows reverse.

Figure 8. Rolling three-month volatility of EM HY Corporate and Barclays US Treasury Indices



Source: Bloomberg as of May 30, 2018.

CONCLUSION

While we have seen a sizeable correction in the valuations of EM debt assets this year, we believe that more is yet to come as we expect financial conditions to tighten further as heavy UST issuance will shift to longer-dated bonds and rolldown of Central Bank balance sheets continues. That, combined with ongoing crowded positioning, may continue to put pressure on the EMD asset class.

We expect that there will be countries that will fare better than others in navigating this tough environment. Once the dust clears, we expect to be able to add risk in these healthier segments of our asset class at more attractive levels.

Phil Yuhn

Portfolio Manager

Phil Yuhn is a portfolio manager on the GLG Emerging Markets Debt team. Prior to joining Man GLG, he worked as a portfolio manager at American Century Investments. Prior to this, he was a senior portfolio manager at HSBC Asset Management from 2009-2015. Prior to HSBC, Phil worked three years in the Emerging Markets Debt Strategy group at Lehman Brothers from 2005-2008. He has been working in the industry since 2005 and holds an MBA from the University of Chicago Booth School of Business. He received a BS and an MEng from Cornell University.

IMPORTANT INFORMATION

This material represents an assessment of market and political conditions at a particular time and is not a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This presentation has been prepared based upon publicly available information and sources, believed to be reliable. Though utmost care has been taken to ensure its accuracy, no representation or warranty, express or implied, is made that it is accurate or complete. The opinions expressed herein are subject to change without notice and neither the author nor Man Group is under any obligation to inform recipients when opinions or information in this report changes. This document is for the use and consumption of the recipient only and may not be printed, sold or circulated or distributed without the written consent of Man Group. Forward-looking statements in this newsletter are not predictions and may be subject to change without notice. Neither Man Group nor any of its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information included in this presentation. All investments involve risks including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. *Investing in sovereign debt securities will expose investors to the direct or indirect consequences of political, social or economic changes in the emerging market countries that issue the securities. The ability and willingness of sovereign obligors in emerging market countries or the governmental authorities that control repayment of their debt to pay principal and interest on such debt when due may depend on general economic and political conditions within the relevant country. These countries may have historically experienced, and may continue to experience, high rates of inflation, high interest rates, exchange rate fluctuations, trade difficulties and extreme poverty and unemployment.*

This information is communicated and/or distributed by the relevant GLG or Man entity identified below (collectively the 'Company') subject to the following conditions and restriction in their respective jurisdictions.

This material represents an assessment of market conditions at a particular time and is not a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular security.

Opinions expressed are those of the author and may not be shared by all personnel of Man Group plc ('Man'). These opinions are subject to change without notice, are for information purposes only and do not constitute an offer or invitation to make an investment in any financial instrument or in any product to which the Company and/or its affiliates provides investment advisory or any other financial services. Any organisations, financial instrument or products described in this material are mentioned for reference purposes only which should not be considered a recommendation for their purchase or sale. Neither the Company nor the authors shall be liable to any person for any action taken on the basis of the information provided. Some statements contained in this material concerning goals, strategies, outlook or other non-historical matters may be forward-looking statements and are based on current indicators and expectations. These forward-looking statements speak only as of the date on which they are made, and the Company undertakes no obligation to update or revise any forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements. The Company and/or its affiliates may or may not have a position in any financial instrument mentioned and may or may not be actively trading in any such securities. This material is proprietary information of the Company and its affiliates and may not be reproduced or otherwise disseminated in whole or in part without prior written consent from the Company. The Company believes the content to be accurate. However accuracy is not warranted or guaranteed. The Company does not assume any liability in the case of incorrectly reported or incomplete information. Unless stated otherwise all information is provided by the Company. Past performance is not indicative of future results.

Financial indices are shown for illustrative purposes only and are provided for the purpose of making general market data available as a point of reference. An index is a statistical measure that shows changes in the economy of financial markets and may serve as a benchmark against which economic and financial performance of an investment is measured. An index is not available for direct investment, and its performance does not reflect the expenses associated with the management of an actual portfolio. All investments involve risks including the potential loss of principal.

Unless stated otherwise this information is communicated by GLG Partners LP, Riverbank House, 2 Swan Lane, London, EC4R 3AD. Authorised and regulated in the UK by the Financial Conduct Authority.

Australia: To the extent this material is distributed in Australia it is communicated by Man Investments Australia Limited ABN 47 002 747 480 AFSL 240581, which is regulated by the Australian Securities & Investments Commission (ASIC). This information has been prepared without taking into account anyone's objectives, financial situation or needs.

European Economic Area: Unless indicated otherwise this website is communicated in the European Economic Area by Man Solutions Limited which is an investment company as defined in section 833 of the Companies Act 2006 and is authorised and regulated by the UK Financial Conduct Authority (the "FCA"). Man Solutions Limited is registered in England and Wales under number 3385362 and has its registered office at Riverbank House, 2 Swan Lane, London, EC4R 3AD, England. As an entity which is regulated by the FCA, Man Solutions Limited is subject to regulatory requirements, which can be found at http://register.fca.org.uk.

Germany: To the extent this material is used in Germany, the communicating entity is Man (Europe) AG, which is authorised and regulated by the Liechtenstein Financial Market Authority (FMA). Man (Europe) AG is registered in the Principality of Liechtenstein no. FL-0002.420.371-2. Man (Europe) AG is an associated participant in the investor compensation scheme, which is operated by the Deposit Guarantee and Investor Compensation Foundation PCC (FL-0002.039.614-1) and corresponds with EU law. Further information is available on the Foundation's website under www.eas-liechtenstein.li. This material is of a promotional nature.

Hong Kong: To the extent this material is distributed in Hong Kong, this material is communicated by Man Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong. This material can only be communicated to intermediaries, and professional clients who are within one of the professional investor exemptions contained in the Securities and Futures Ordinance and must not be relied upon by any other person(s).

Liechtenstein: To the extent the material is used in Liechtenstein, the communicating entity is Man (Europe) AG, which is regulated by the Financial Market Authority Liechtenstein (FMA). Man (Europe) AG is registered in the Principality of Liechtenstein no. FL-0002.420.371-2. Man (Europe) AG is an associated participant in the investor compensation scheme, which is operated by the Deposit Guarantee and Investor Compensation Foundation PCC (FL-0002.039.614-1) and corresponds with EU law. Further information is available on the Foundation's website under www.eas-liechtenstein.li.

Switzerland: To the extent this material is distributed in Switzerland, this material is communicated by Man Investments AG, which is regulated by the Swiss Financial Market Authority FINMA.

United States: To the extent his material is distributed in the United States, it is communicated by GLG LLC. and is distributed by Man Investments, Inc. ('Man Investments'). Man Investments is registered as a broker-dealer with the US Securities and Exchange Commission ('SEC') and also is a member of the Financial Industry Regulatory Authority ('FINRA'). Man Investments is also a member of the Securities Investor Protection Corporation ('SIPC'). GLG LLC is registered with the SEC as an investment advisor. GLG LLC. and Man Investments are members of the Man Investments division of Man Group plc. The registration and memberships described above in no way imply that the SEC, FINRA or the SIPC have endorsed GLG LLC, or Man Investments. Man Investments, 452 Fifth Avenue, 27th fl., New York, NY 10018

2018/US/GL/I/W