Francesc Balcells, Portfolio Manager
Aristea SICAV FIM GEM Debt

Do you believe the current dividend yield offered by EM bonds could balance out risks an investor is taking?

The yield to maturity offered by emerging market dollar-denominated bonds is 5.2% today. This 5.2% covers essentially two risks: interest rate or duration risk, and credit or country risk. Since the bonds are denominated in dollars there is no currency risk, or just EUR-USD risk for EUR-based investors, a risk which can be hedged cheaply.

Year-to-date the **duration risk** has been the biggest driver of returns for EM bonds.

But we think this will change as the Treasury market is showing signs of consolidation following a very sharp move in US yields since mid-last year.

Valuations, positioning, and flows all support a more range-bound Treasury market, or at the very least we expect yields to move in a more gradual fashion going forward.

Historically EM bonds tend to produce very good returns after a period of adjustment in Treasury yields.

On the **credit** side the spread of EM bonds against US Treasuries is now running at 348bps which is above its historical 10yr range. Prior to the Corona crisis, the EM spread was trading as low as 261 bps, so **we see a lot of scope for spread compression** here, particularly in the context of a global environment defined by high growth and high commodity prices, which is extremely favorable for EM risk.

Of note, EM debt, which is mostly rated investment-grade by the rating agencies, is now trading wider in spread terms than US and global High Yield, which is highly unusual, and speaks of the cheapness of EM debt vs. other similarly risky asset classes within the fixed income universe.

What EM bonds (in terms of country, creditworthiness, currency) do you think are to be overweighted and what are to be underweighted currently in your portfolios?

We see a lot of **value in USD-denominated bonds** for the reasons expressed above.

And within that group, we favor the **high-yield segment** of the asset class for three reasons. One, these bonds tend to have a very high yield of between 7-8%, thus giving investors plenty of income protection against unanticipated events, and a nice cushion against Treasury risk.

Second, **high yield credits tend to be a "high beta" expression** of global risk and global growth. As such, in the current global backdrop, we think those names have a lot of room to do well.

Third, **high-yield names tend to have shorter duration** than their IG counterparts, and therefore should do better in an environment of higher Treasury yields.

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In terms of countries, our biggest position in the portfolio is **Oman**, in the Gulf. The USD bonds are trading with yields of between 5-7%, and the country (and the region) is going through some powerful structural political and economic adjustments that should act as catalysts for price appreciation.

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