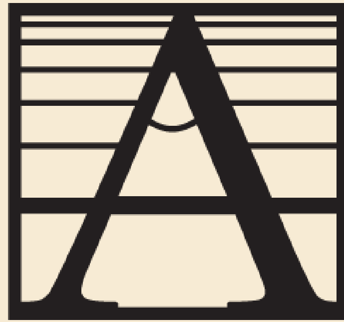

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Market overview, Q3 2017

Market overview, Q3 2017

Q3 2017 saw a strong risk appetite on the back of rising oil prices, which gained 20% quarter-on-quarter. Cash inflows into EM funds have set new record highs in the last five years. Funds focused on local currency bonds are a bright example, although demand for USD-denominated bonds is also great.

The US government debt market was traded sideways, e.g. 10-year Treasuries traded at 2.0–2.4%, hitting this year's low in early September. Yields of 10-year US Treasuries have already grown by 100 bps since July 2016 bouncing back from the historical low of 1.4%. In the wake of a tighter monetary policy, most players expect yields to grow further, but so far the macroeconomic landscape has not helped to bring this scenario to life.

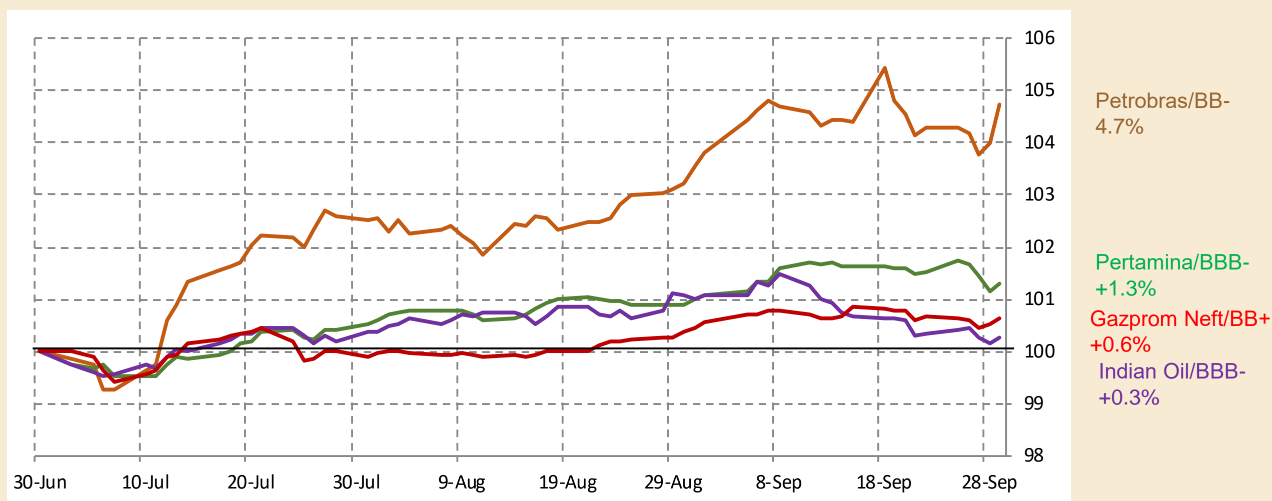
Market indicators. Index performance, Q3 2017

RTS	14%
S&P	4%
EURO STOXX 50	4%
Gold	3%
Brent	20%
UST 30 yield, bps	2

UST 10 yield, bps	3
UST 5 yield, bps	5
5-year CDS for CEEMEA, bps	-14
5-year CDS for Russia, bps	-27
EUR/USD	3%
RUB/USD	-2%

In Q3, high-yield securities saw the strongest demand on the back of high risk appetite. New offerings were several times oversubscribed, with allocations being often as low as 10% or less. Unmet demand was absorbed in the secondary market driving price growth for listed securities. Brazil's bonds, where economy is performing fairly well, were among the champions, though corruption scandals in the country rumble on.

Changes in bond prices of government-owned oil and gas companies from Russia, Brazil, Indonesia and India* in Q3 2017



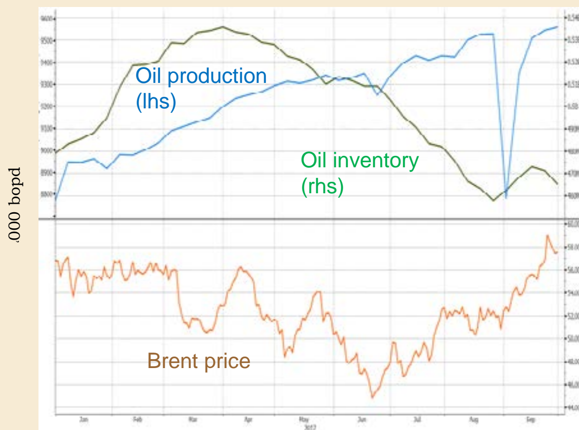
Source: Bloomberg as at 13 October 2017

*Sibneft-23 (Gazprom Neft), Petrobras-23, Pertamina-23, Indian Oil-23

Commodity market and the Middle East

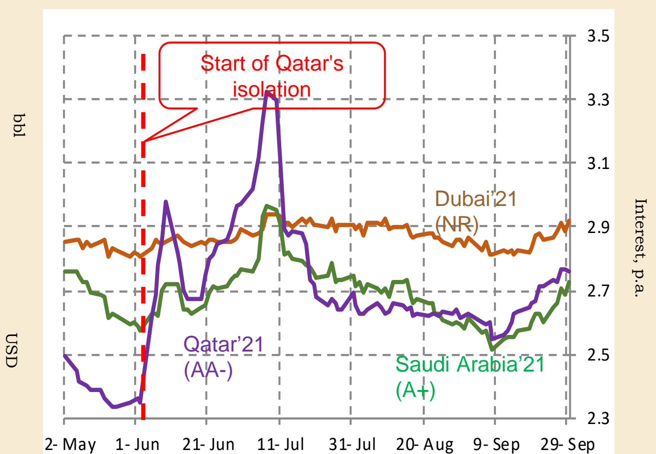
Brent has fully recovered from its decline since the beginning of the year by gaining 20% quarter-on-quarter. Growing prices were supported by demand from Asia, lower US oil inventory and uncertainty around oil supplies from Libya, Venezuela and Iran. Having recovered from the tornado season, US oil production keeps going up. According to the EIA, after this year's major drop in oil inventory, in 2018 the supply and demand in the oil market will be balanced. Strong price hike is not expected by experts: projections assume production growth in non-OPEC countries at the global demand growth rates. According to analysts, oil trading in the range of USD 50–60/bbl would be suitable for all market players.

Oil price rose amid declining inventory



Source: Bloomberg as at 16 October 2017

Qatar's bonds roughly half-recovered*



Source: Bloomberg as at 16 October 2017

Qatar's diplomatic crisis eventually left the headlines, though the country is still under isolation. Most countries, including the USA, tend to be neutral and urge a diplomatic solution. The conflict is dragging on, but escalation risks are going down, though. Overall, Qatar has quickly found new channels for imports and trade, and avoided an inflation hike. The crisis has empowered the reform momentum to diversify the country's economy. The government shielded the banking sector by offering deposits and increasing repo facilities to banks hit by capital outflows. This quickly restored banking liquidity, supporting banks and their Eurobonds. Qatar's strong gold and foreign currency reserves (USD 340 billion, or about 200% of GDP)** are more than ten times the country's FX debt (USD 32 billion as at 31 December 2016). Furthermore, lower imports and higher oil prices year-on-year are expected to bring about a surplus in the current account this year, which should also support gold and foreign currency reserves.

Qatar's Eurobonds roughly half-recovered, but the spread we see for certain securities is still attractive. We increased our exposure to this region and maintain it.

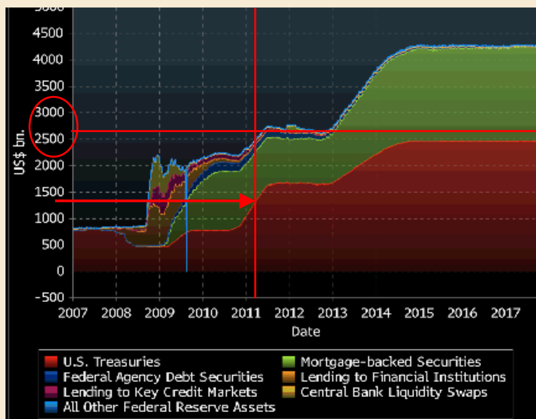
* Yield on sovereign bonds maturing in 2021

USA

Market players share no consensus as to the future trend of US Treasury yields after the Fed cuts its holdings and hikes the interest rate. Some analysts are apocalyptic and see this as a death sentence to the bond market as such. In our view, not only the magnitude of yield growth matters, but also how fast this growth would be.

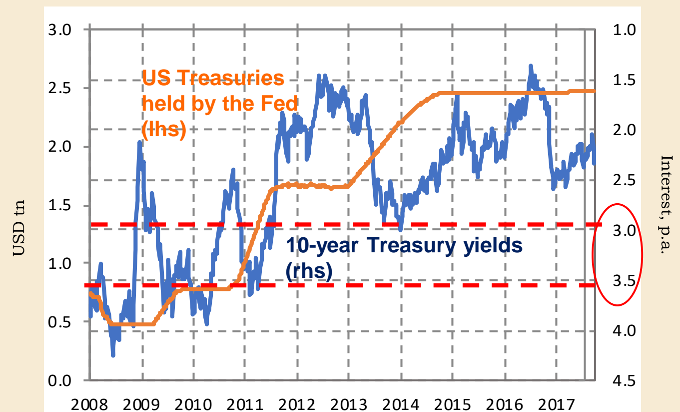
The Fed released a detailed plan to reduce its balance sheet, which should not go down below USD 2.5 trillion in the next few years. If we take this figure and yield levels seen at the same time several years ago, 10-year US Treasury yields were at 3.0–3.5%. As at 30 September 2017, yields on 10-year US Treasuries were at 2.33%, and an uptick of 70–120 bps would hardly pose a serious blow to the bond market, if the process takes a few years.

Evolution of the Fed's holdings



Source: Bloomberg as at 16 October 2017

US Treasuries held by the Fed and 10-year Treasury yield

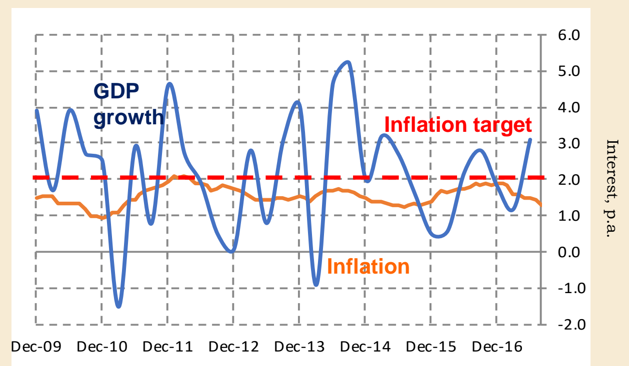


Source: Bloomberg as at 16 October 2017

Inflation has not yet shown strong signs of growth. Yet, infrastructure spending announced by the US President Donald Trump may unleash it. So far, the White House initiatives have been facing resistance, and the spending amounts and timing are still unclear.

Non-monetary theories of inflation are gaining ground. Global integration made human resources more mobile, cutting the cost of man-hour in developed markets and therefore employee income, hence reducing demand. Changes in interest rates mostly affect the supply side through cheaper loans intended to fuel businesses. The latter, however, leave these resources untapped, as they are unsure of finding demand. This might be the reason behind the stagnant inflation in spite of strong cash injections from central banks.

Inflation has long been below the Fed's target



Source: Bloomberg as at 16 October 2017

If this theory is true, no inflation rises or falls driven by the Fed's moves should be expected in the near term. By and large, this would be good news for the bond market.

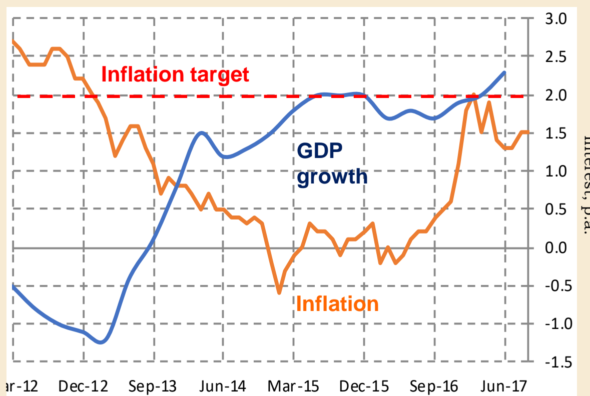
Europe

In Europe, focus has shifted from economy to politics. Nationalist parties are gaining more and more electoral votes across the continent. Though still far from an absolute majority, they have just beaten the former governing coalition parties in state elections in Germany. This means that now their demands must be taken into account, and there is a need to compromise.

The ECB policy has remained intact with the refinancing rate kept at 0% since April 2016. The bank is still buying EUR 60 bn of bonds a month, but the programme could be sized down to EUR 30 bn. ECB is known for its cautious stance towards any changes in the monetary policy. With inflation still not strong enough and economic growth uneven among the EU countries, Mario Draghi is reluctant to taper the stimulus programme.

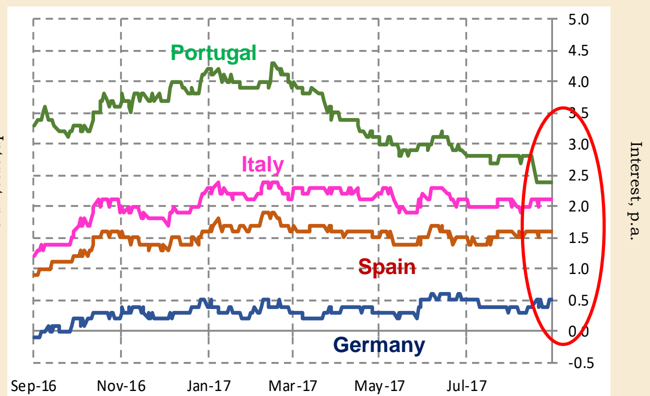
In terms of investment case, euro-denominated bonds are still of no interest. Market players ignore both political tensions (such as the Catalan independence referendum) and weaker credit fundamentals of certain countries and companies.

Eurozone inflation is still below ECB target



Source: Bloomberg as at 18 October 2017

Most EU yields* still lack appeal for investors



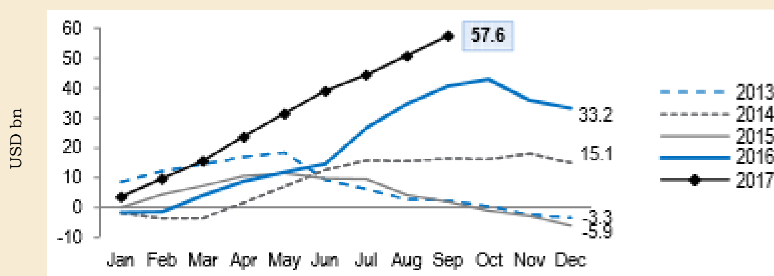
Source: Bloomberg as at 18 October 2017

*10-year government bond yields

Emerging markets

In Q3 2017, emerging markets, including bonds, enjoyed continued capital inflows. With a strong risk appetite fuelled by growing commodity prices and improving fundamentals across most EMs, investors have been allaying their concerns about rising geopolitical tensions and balance sheet tapering by the world's major central banks.

Strong capital inflows to EM Eurobond markets (YTD)



Source: JPM as at 29 September 2016

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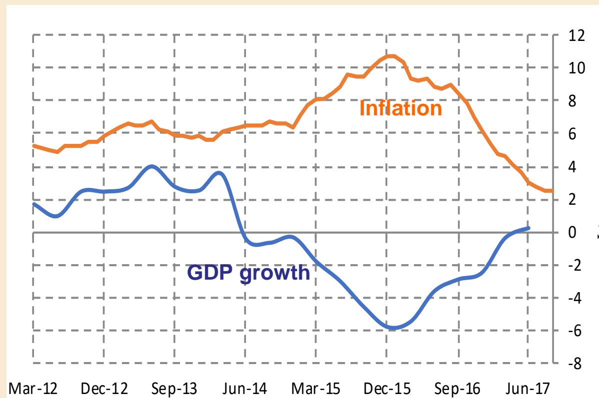
Emerging markets

Credit spreads almost in all EM countries narrowed driven by the overall investor risk appetite, rather than country-specific factors. In Q3, Brazil, which had previously lagged behind, was in great demand. As the country maintains strong economic performance, this overshadow new details of the unfolding anti-corruption scandal that keep popping up.

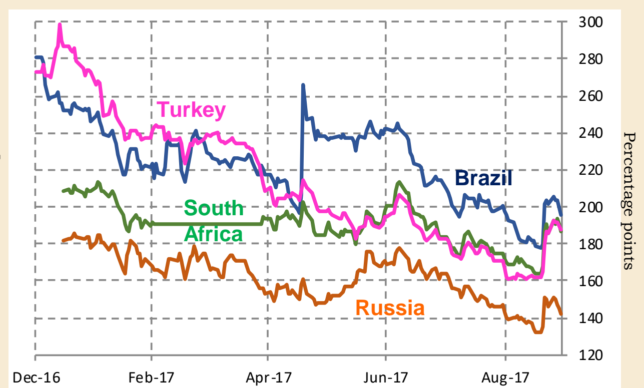
The Mexican bond market rejoiced at the S&P's decision to upgrade the country's credit rating (BBB+) outlook from negative to stable. Commenting on the improved rating, S&P cited that "Mexico's general government debt burden is forecast to hover around 45% of GDP this year and next, and remain below 50% for the next two years". Moreover, the agency's base case scenario is that the USA, Canada and Mexico will come to a new arrangement with respect to the free trade agreement.

Brazilian economy demonstrates strong signs of recovery



Source: Bloomberg as at 18 October 2017

Some EM credit spreads year to date



Source: Bloomberg as at 19 October 2017

Russia

The Russian Eurobond market is becoming increasingly like that in Asia in terms of capital flows and reactions to external factors. According to market participants, local investors, predominantly banks, account for 30% to 50% of Russian Eurobond holdings. Typically, they ignore external factors and restrictions (such as sanctions) and hold assets till maturity. Hence, the Russian Eurobond market is safeguarded from externals shocks. Foreign investors are not expected to scale up their presence in the Russian market sizably in the near term due to the country's below investment grade rating and sanctions. All this adds up to sensitivity to any internal influences.

The Russian Eurobond market has considerably shrunk in recent years on the back of bond redemptions and buybacks, not to mention relatively small size of new offerings. The macroeconomic situation has also stabilised with GDP growth projected at 2% and inflation falling down to 4–3%. We believe that Russian Eurobonds may be of interest for those willing to diversify against global volatility due to their low sensitivity to fluctuations and short duration.

Our response

In July, portfolio managers continued to take profit on long Eurobonds. We have also participated in the repurchase of a part of 2023 bonds by Chilean retailer Cencosud. Russia's Alfa Bank has repaid its debt. In early July, we invested in CEMEX (BB-) 3.24% bonds maturing in 2024. CEMEX is a Mexican manufacturer and seller of construction materials, and the world's third largest cement producer. The company's operations span 20 countries across the globe, and its revenue in 2016 amounted to USD 13.5 bn.

In September, the Fund managers took profit on euro-denominated bonds, reducing their EUR positions to 3.5%. They also continued reducing long duration positions and closed the leverage which stood at 1.5%. The Fund took part in the following primary offerings: 4% NLMK bonds due 2024 (Russian steelmaking, BBB-), 4.125% SIBUR bonds due 2023 (Russian chemicals, BB+), 4.19% Santos bonds due 2027 (Australian gas production, BBB-), 4.1% Mexichem bonds due 2027 (Mexican petrochemicals, BBB-) and 4.4% KazTransGaz bonds due 2027 (Kazakh gas transportation, BBB-).

Outlook

Continuous lack of significant correction makes its occurrence more likely with every month that passes. Among the potential correction triggers are the escalating North Korean crisis, the lukewarm conflict with Qatar, a black swan from China or new disappointing data from Europe. The correction can be postponed should market players decide to adopt a defensive approach in an attempt to minimise the risks and take the profits made over the fairly lucrative year. Therefore, we keep looking for new ideas and aggressively seek primary offerings where issuers offer premiums to the secondary market investments. At the same time, we take profit on the securities that are already expensive. We do not rule out that the Fund's cash position may go up to as much as 10%.

We hope you find this information useful and will be glad to answer your questions.

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