EMERGING WORRIES?

Seven Investment Management

The performance of emerging markets debt has surprised many investors. But is it something to be concerned about?

The Great Financial Crisis (GFC) has created many distortions, particularly in bond markets. Who'd have thought some high-grade corporate bonds would yield less than UK gilts, as they did during the credit crunch? Few predicted UK interest rates would remain at a 300-year low of 0.5% for more than three years. And many investors have been caught out by a government bond rally that has lasted for such a long time.

Over time, though, the market has adjusted to the 'new reality' in which we are living. With government yields offering safety but little value – particularly as inflation has turned real returns negative – investors have predictably edged further out the risk spectrum in search of better yields.

That has taken them to high yield bonds and emerging market bonds. These higher-risk and higher-yielding assets have performed well in the past two and a half years as demand for higher yields has driven spreads over government bonds lower.

But the outperformance of emerging market debt has been particularly stark. This was evident in the third quarter of last year, when the Euro crisis undermined high yield bond markets but did not affect emerging market debt. As a result, the relative valuation between the two soared.

This has partially reversed in 2012, as European high yields bonds have performed better thanks to the resolution (of sorts) of the Greek crisis. But the fact remains that valuations of emerging market debt are very close to their pre-Lehman Brothers highs, while valuations of other 'spread products' like high yield and investment grade bonds are still well away from those peaks.

Admittedly, there are some good reasons for this. High yield and investment grade credit is typically listed in the developed world, where investors are still demanding a premium for holding assets that remain sensitive to the sovereign debt crisis. And emerging market debt is linked to growth in these economies, which have become market darlings since the GFC undermined confidence in Western economies and markets.

Investors should be mindful, though, that while governance, economic policy and political stability has undoubtedly improved, there are risks to investing in these areas. At the moment, high inflation and concern about a Chinese economic slowdown are key risks to the ability of emerging market politicians and central bankers to keep their economies on track. When it comes to investing in emerging markets – equity or debt – it pays to do your homework.

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The views expressed in this article are the writer's own and do not necessarily reflect those of the 7IM Investment Team.

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