TIME TO LOOK BEYOND LABELS…

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Key points

- Labels like the 'Fragile Five' are sensationalist and often misinform investors on emerging markets
- Some commentators are now pointing to Mexico, Colombia, Indonesia, South Africa and Turkey as the most 'fragile' emerging market economies
- Emerging markets are increasingly relevant in a global context with nine emerging markets in the world's 20 largest economies
- Successful investment into emerging bond markets relies on a thorough assessment of opportunities and an understanding of the potential rewards relative to the risks
- This is why our investment process combines top-down and bottom-up themes to drive a deep understanding of the opportunities on offer

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Trying to attach a label to a vast and varied asset class like emerging market bonds is a precarious business. No one size fits all. Just as the once ubiquitous BRICS label is well past its sell by date, current attempts to categorise a "Fragile Five" must also be viewed with scepticism.

During the 'taper tantrum' in the summer of 2013, when emerging bond markets sold off aggressively over fears of an impending US rate rise, various commentators began to talk of the 'Fragile Five' – namely the five economies that had suffered most as a result of the market upheaval.

At the time, the five countries that were most dependent on overseas investment flows were Brazil, India, Indonesia, South Africa and Turkey. Since then, these economies have tended to receive short shrift from the investment media. More recently, some observers have argued that the constituents of the 'Fragile Five' have changed and that Colombia and Mexico have now joined the group, replacing India and Brazil.

Such labels fall a long way short of reflecting the true picture. Despite the challenges now facing many emerging bond markets, according to World Bank figures, the BRIC nations (Brazil, Russia, India and China) are all still among the ten largest economies on the planet. Indeed, its list of the world's top 20 economies by size features no less than nine emerging markets. This means that each of the 'Fragile Five' economies is far too important in economic terms to be simply dismissed from consideration.

Fragile thinking

There's no question that a number of factors have increased the challenges for emerging markets and that, for a good many, the fundamentals have deteriorated. But it's a huge oversimplification to, in effect, apply the 'fragile' label to the entire asset class based on an unbalanced view of a small number of metrics, or to suggest that investors somehow avoid investing in around half of the world's largest economies.

Currently, Turkey and South Africa are still challenged thanks to their large external imbalances and the significant political risks they carry. Due to its reliance on short-term funding, Turkey has been labelled as the most vulnerable emerging debt market for some time. Meanwhile, the collapse in the oil price has decimated Colombia's government revenues. The peso has declined by more than a third in the last year, while its current account deficit, which must be funded by external capital, has ticked up towards six per cent.

Mexico too finds itself caught in the headlights due to the parlous state of its reserve coverage ratio – namely the extent of its foreign exchange reserves when divided by its funding gap. This has fallen to just 1.6 years, which looks thin even by emerging market standards. At the same time, with interest rates already low, observers fret that the Mexican central bank lacks the firepower to provide more stimulus should its economy weaken still further.

Although these all present significant challenges, investors need to balance these problems against the country's robust growth outlook, its favourable political environment, constructive fiscal policy and the value of its deep trade links with the United States.

Elsewhere, despite its burgeoning long-term potential, which is supported by ongoing reforms and strong demographics, Indonesia has suffered significant capital outflows in the short term that have been exacerbated by its declining growth outlook. These issues require careful analysis, especially at a time when the US is in the process of normalising interest rates. However, investors must look at the balance of positives and negatives and consider the risks in a global context.

The big picture

Any number of emerging economies can look 'fragile', depending on the choice of metrics employed. For example, Brazil is a major commodity exporter with a widening current account deficit, spiralling political scandals, worrying credit growth and a current account deficit that's twice the size of Mexico's at 4.3 per cent. To some, this would suggest it is more vulnerable than its Latin neighbour. Despite this, Brazil is simply too important an economy to ignore, but making the best of the opportunities it offers requires thorough analysis.

Elsewhere, Malaysia, another oil exporter reliant on foreign investors, is struggling with the stigma of a Prime Minister mired in a sovereign wealth fund scandal that runs to billions of dollars – an intrigue that has hastened the precipitous decline in its currency. The negative focus on China also continues to mount. The bursting of China's stock market bubble, fears of its inevitable economic slowdown and two attempts to devalue the renminbi this year triggered a capital flight estimated at close to US$270 billion in July and August alone.

Of course, the issues faced by each of these economies are balanced out, to some degree, by any number of positive factors. These include promising election results in India, Indonesia or Turkey, which have improved political stability, or the credibility of the political systems and financial institutions in Mexico or Colombia.

From an investor's perspective, success in emerging bond markets isn't about balancing out the positives and negatives at a macroeconomic level or attempting to avoid those countries that have suddenly found themselves labelled 'fragile'. It comes down to being able to differentiate between different bond issuers based on a broad spread of factors and building a well diversified portfolio to capture the long-term potential on offer in emerging markets.

Change creates opportunity

This requires detailed analysis of both top-down macro factors and bottom-up themes. The challenge facing any emerging market bond investor is to recognise the extent of the risks facing each issuer and to decide whether the yields on offer adequately compensate for these risks.

In this respect, it differs very little from any other asset class. Investors focused only the strongest economic fundamentals will quickly find that their portfolios offer little in the way of diversification and that, absent such risk, the returns they generate are likely to be some way behind those of more risk-tolerant investors.

The emerging market universe is poised at a key juncture. We have reached the point in the valuation cycle when many of the problems facing emerging markets have been priced in or, potentially, over priced. As such, we expect a number of areas to begin to show real value in the months ahead. However, to capture these opportunities investors will need to do more than just rely on the latest label.

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