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News & Views

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The new reality of EM debt

The "direction of travel" rather than the absolute rate of growth is what is important for investors this year, says Colm McDonagh, head of emerging market debt (EMD) at Insight, a BNY Mellon company[1].

Speaking at BNY Mellon's Global Investment Conference in late April, McDonagh says: "The three largest economic areas in the world are growing: China, the US and Europe. They are growing at different rates but compared with last year when people were really concerned about Chinese growth disintegrating and the lack of growth in Europe the trends are improving. Now we believe the world is doing ok."

He believes regardless of US President Donald Trump's ability to pass tax reform and/or infrastructure spending ("which, by the way, we are not seeing any evidence of") there is an overall improvement in the US in the past couple of years.

Source: Thomson Reuters Datastream, HSBC estimated. Notes: 2017 GDP forecasts are HSBC projections, GDP level are nominal 2016 values in USD. The size of the bar shows the magnitude of contribution to global GDP growth for 2017.

Still, he believes the phrase 'when the US sneezes the rest of the world catches a cold' is nowhere near as relevant as it was a few years ago.

"The emergence of China and some other emerging economies is significantly more important in terms of global trade and global growth, particularly for investors interested in EM.

"Elsewhere in EM, India certainly doesn't have the economic heft or weight of China but it is growing at a rapid rate and other countries are also growing well, or at least at an improved rate compared with the past couple of years."

Duration risk

This positive growth momentum could lead to fears of inflation and thus duration risk within fixed income assets, says McDonagh. However, fundamentally he believes these fears are overdone.

"In the US growth is improving but not at a rapid rate – tax reform and infrastructure spending are going to

[1] **Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.**

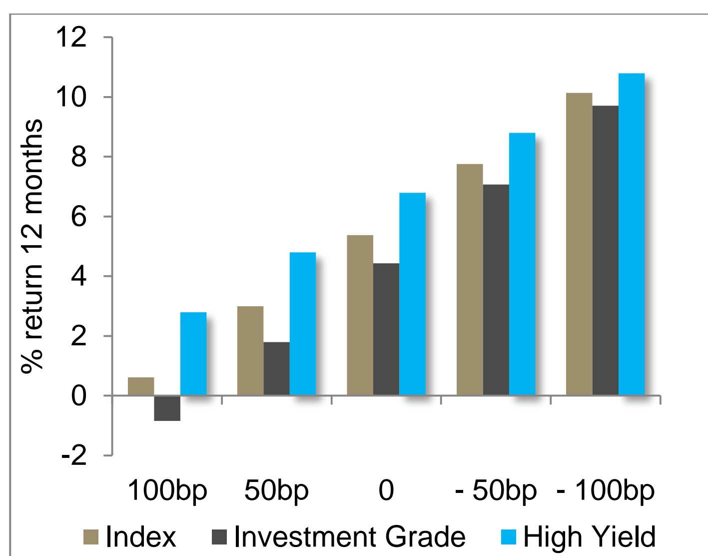
be almost certainly delayed so we do not see inflation as a problem. Headline inflation rose with the oil price recovery last year but that increase is now coming out of the numbers. So headline and core inflation is not as high as most people thought it would be at the start of this year."

McDonagh believes Europe is more of a risk in terms of duration: "If you look at 10-year bunds today, they are trading at roughly 20bps there is more of a risk that they need to normalise to between 50bps and 80bps," he comments.

In the US on the other hand, 10-year Treasuries are trading in the range of 230bps and 260bps and he believes there is not too much risk of them going out of that range by the end of this year - certainly nowhere close to 400bps as some people were predicting.

When it comes to EM assets and their relationship to Treasury yields, McDonagh believes the higher yields give some insulation to a duration move. "If Treasuries did nothing for the rest of this year and stayed at current yields, you would get around a 5.5% return at current spreads. I think a lot of people in this room would be satisfied with that. If US Treasury yields dropped by 50bps then there would be an even more attractive return. While if yields were to rise by 100bps you could say your worst case scenario is that you don't make any money."

Sensitivity to US Treasury yield shifts



Source: JP Morgan, Bloomberg, Insight Investment, as at March 2017.

Political risk
There are a number of significant political events in EM the remainder of this year: such as mid-term elections in Argentina and the choice of President Zuma's successor in South Africa.

"We look at over 70 countries, so there are always going to be some political events in EM," says McDonagh.

"However, the greater political risks, arguably, are in Europe and the US: The announcement of a snap election in the UK and the German elections coming up in September," he adds.

He believes the reason bund yields are so low is because investors are worried about Europe and are looking for a 'safety trade', which leads to a "flight to quality".

Currency volatility
Says McDonagh: "Every economic and political shock you get in any country in the world will be reflected through currency. So currency volatility will remain and spike at different points, whether that is in Europe, South Africa, the UK and even the US.

"I don't think there is as much risk in bond yields or to credit quality but I think there will be considerable volatility in FX should political shocks come to pass."

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BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕一般社団法人　投資信託協会
一般社団法人　日本投資顧問業協会
一般社団法人　第二種金融商品取引業協会