Emerging Market Rates Strategy

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Market environment

JP Morgan's Government Bond Index Emerging Market (GBI-EM) Global Diversified Index was up strongly in August (+3.07%) as US bond yields declined modestly and the USD weakened. Central and Eastern Europe, Middle East and Africa (CEEMEA) and Asia led the way, whereas returns in LatAm lagged (-0.53%) were negative on the month, dragged down by a sharp fall in Mexico and only modestly positive returns elsewhere. On a country level, Asian countries, including Indonesia, Malaysia and Thailand, were the star performers.

Performance

The strategy disappointed during the month, capturing only 37 basis points of these returns. The strategy benefitted once again from being long Turkey FX, which gained on the back of very high implied yields and the Central Bank of Turkey's commitment to keeping interest rates high until inflation starts to come down. These returns were supported by long FX positions in CEE (Hungary, Poland) and long rates positions in some of the high yielders like Colombia. However, this was somewhat offset by a long position in Mexico FX – the currency lost more than 5% on the month amid concerns over judicial reforms.

The main detractors were once again short FX positions in Asia and Europe. The rally in the Japanese yen dragged most Asian currencies along with it, and the strategy's short positions in the Thai baht and Chinese yuan weighed on performance as a result. The decline in US rates also supported other Developed Market (DM) currencies against the USD, which meant that the short positions in funding currencies such as the EUR were also costly.

Performance contributors

- Long Hungary FX
- Long Turkey FX
- Long Colombia rates

Performance detractors

- Short China FX
- Short Thailand FX
- Short EUR

Outlook

Growing evidence of a moderation in inflation in both EM and DM has ensured that the strategy remains long rates in both DM and EM economies. Expectations of resilient growth have kept the strategy long EM FX, and the USD risks are hedged by shorts in DM currencies such as the EUR, AUD and CAD and lower-yielding EM currencies such as China's CNY/CNH.

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