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 July (+2.27%) as US bond yields declined and the USD weakened. Central and Eastern Europe, Middle East and Africa (CEEMEA) and Asia led the way, gaining +2.51% and 2.68% respectively, while LatAm lagged (+0.80%) due to negative returns in Brazil and Mexico. On a country level, Hungary, Peru, South Africa and Thailand were the star performers.

Performance

The strategy captured the bulk of these asset class returns and was up 1.62% on the month. The strong performance stemmed largely from our long positions in Czech rates and Turkey FX, and a received position in Developed Market (DM) rates. Czech rates benefitted from a large downside inflation surprise, whereas Turkey FX gained on the Central Bank of Turkey's commitment to keeping interest rates high until inflation starts to come down. These returns were supported by long rates positions in countries such as Brazil, Colombia and Mexico.

The main detractors were short FX positions in Asia and Europe. The Japanese yen rallied sharply in July and dragged most Asian currencies along with it. Two important beneficiaries were the Thai baht and Chinese yuan, both of which we were short. Other currencies that are frequently used to fund carry trades also rallied, so our short euro position also weighed on performance. The unwind of the carry trade also hurt the currencies of the traditional high-yielders such as Brazil and Mexico, both of which were down on the month.

Performance contributors

- Long Czech rates
- Long Turkey FX
- Long DM bonds

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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