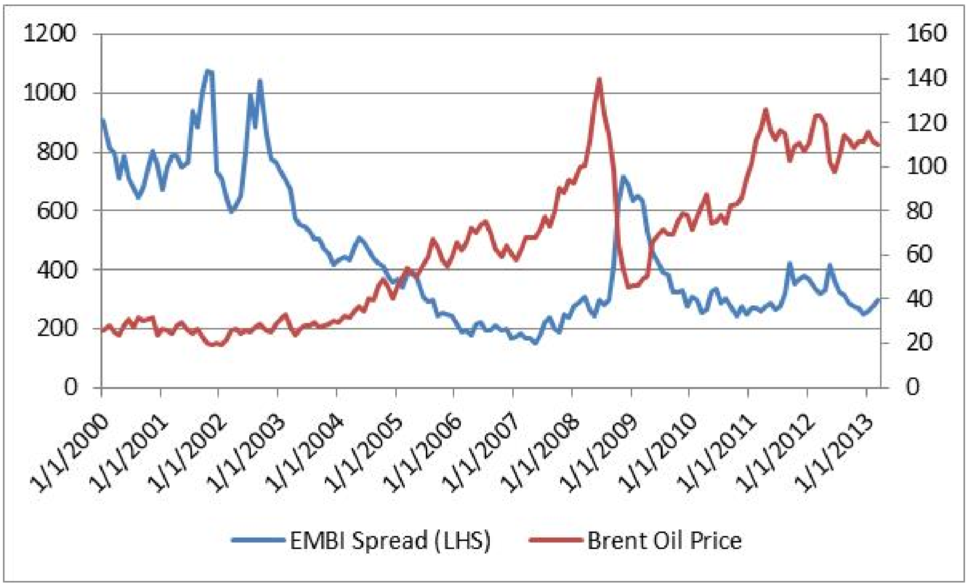
Emerging market bonds have probably been the single best trade of the last 10 years. Careers have been made, funds launched and businesses built on the back of this huge bull market. When you have a 10 year bull market where most of the participants have never seen a sustained bear market the first sell-off can often be very substantial.

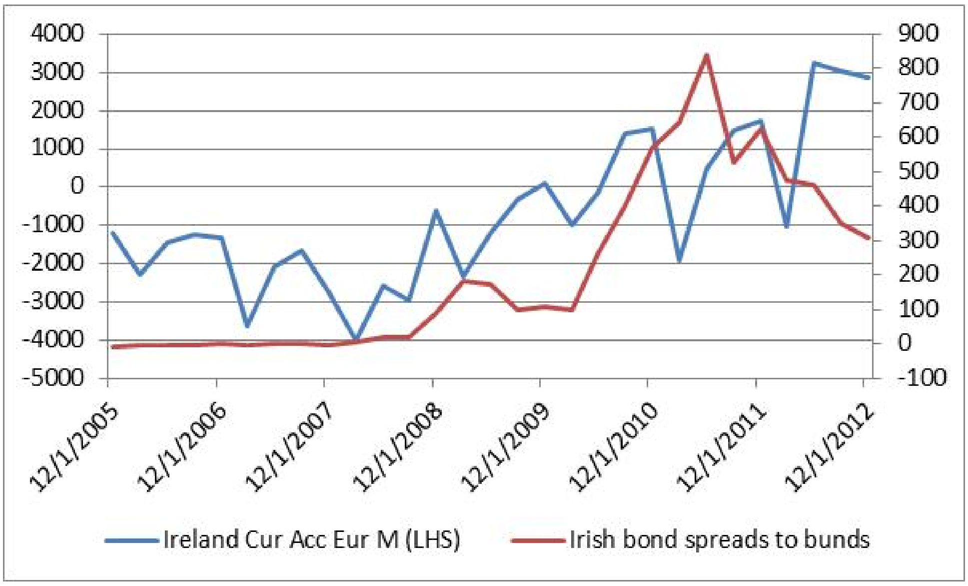
I have written about sovereign bonds before – most notably on peripheral European bonds as buys in 2011. What is interesting about emerging market bonds is that they share many of the same characteristics of peripheral European bonds BEFORE the Eurocrisis began, being, deteriorating current accounts and a greater reliance on credit expansion for economic growth.

10 years ago there were few large emerging market sovereign issuers and almost all bonds were issued in US Dollars. These days emerging market bond funds have many more issuers to play with and it is now possible to invest in local currency bonds for both government and corporate issuers. For the moment, this note will look at the large sovereign issuers that make up the key members of emerging market bond indices. Typically, this includes Russia, Brazil, Mexico, Venezuela, Turkey, Indonesia and South Africa. (Notable exclusions are China and India as they have almost no external debt so their debt is generally not found in emerging market bond funds.) All of these countries tend to find their economic fortunes tied to commodity exports (while Turkey is not a commodity exporter, it has very strong trade links to commodity exporting nations).

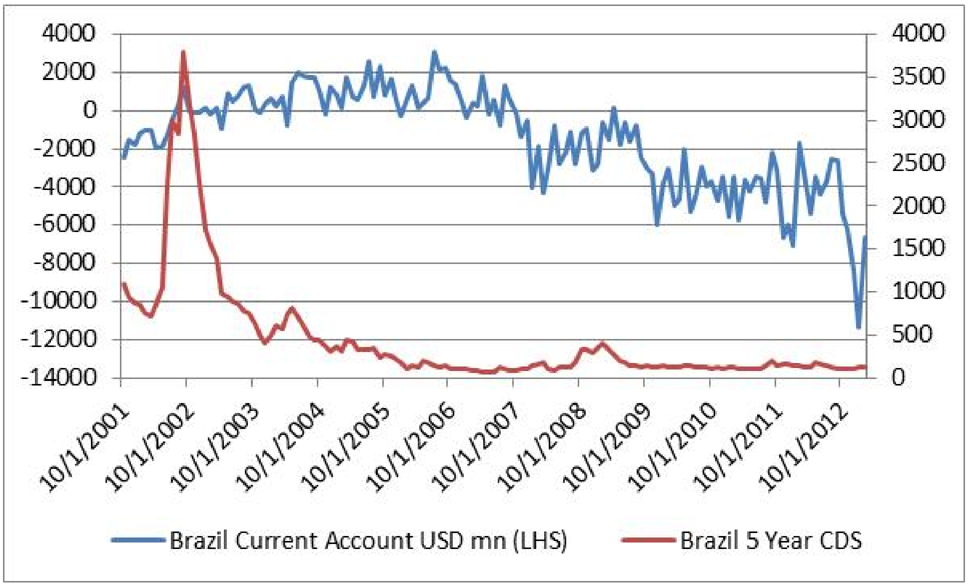


The above chart shows the spread in yield between USD bonds issued by sovereign emerging markets and the US treasuries (EMBI Spread) and the oil price. Of course the oil price and bond spreads may both reflect strong global growth, but that they tend to trade together is important in my view.

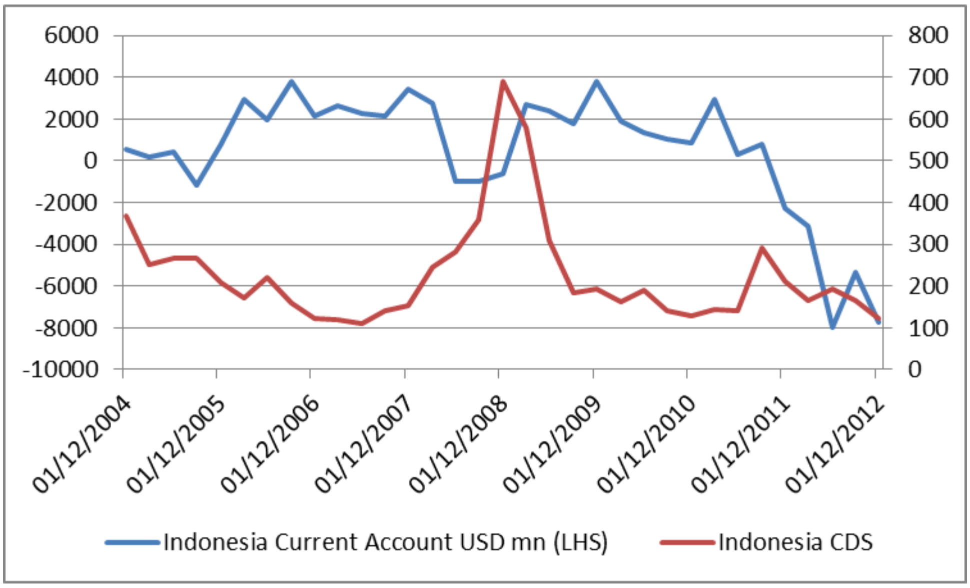
Ireland was one of the first and most extreme casualties from the Eurocrisis. As can be seen below, Irish debt traded in line with German bunds. Irish creditworthiness was only questioned after many years of current account deficits. Once Ireland moved back to current account surplus its borrowing costs began to fall.



With that in mind, the Brazilian current account and borrowing costs seem consistent with peripheral Europe pre-crisis.



We can see a similar dynamic in Indonesia.



Finally, many of the emerging market debt issuers have an over reliance on the export of a single good. Russia, Venezuela and some other emerging market borrowers have a high reliance on oil for government revenues. For most oil producers the strong oil price means that they run strong current account surpluses. This is probably why we see a strong correlation between the Brent oil price and the EMBI spread.

While I have been bearish on mining stocks and commodities for more than two years, the market has also come to recognise the problems within these areas and have priced stocks accordingly. However, for some reason the market has hardly priced in any of these implications into emerging market currencies and bonds. In my view emerging market bonds and currencies are now looking the most attractive area to short.

Information

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