ROBUST START TO THE END-OF-YEAR RUSH – BONDS FROM EMERGING ECONOMIES REMAIN ATTRACTIVE

After three strong quarters for emerging markets bonds, fund manager Robert Reichle remains optimistic for the fourth quarter too. Reichle manages the Berenberg Emerging Markets Bond Selection Fund, which focuses on government bonds in hard currency, and does not see any greater risk from the development of the US interest rate. Instead, most emerging economies are delivering convincing fundamental data. His favourites include Indonesia and the Dominican Republic. But he has also given a relatively strong weighting to outsiders like Ghana and Egypt.

Government bonds from the emerging markets in hard currency have already yielded a total of roughly 8.0 percent this year. Nevertheless, Robert Reichle still sees some headroom: "While the risk premiums compared with US government bonds have already narrowed by roughly 45 basis points, we certainly still see potential for a further drop of around 20 to 25 basis points by the end of the year." Indicators that this could be the case include the strength of the US economy, which is likely to buoy trade with the emerging markets, and the extremely robust fundamental position in most of the emerging countries.

However, the Berenberg fund manager does not expect any major jump in earnings during the rest of this year. The falling risk premiums could be counteracted by increasing yields from US government bonds, which have a direct impact on the overall yield of emerging markets bonds listed in US dollars. The decisive factor here is above all else the returns on long-term bonds that run for ten or 30 years. Because expected inflation rates did not eventuate, these returns were on the decline this year, also resulting in price gains for emerging markets bonds.

Falling risk premiums likely to compensate for rising US interest rates

Despite continued low inflation, the Federal Reserve announced – as expected – at its most recent meeting in September that it would start to shrink its bloated balance sheet, indicating a further interest movement in December. "The market is likely to price in this potential increase from now. However, this will probably be reflected in the returns on short-term US bonds especially, thus having a limited impact on emerging markets bonds. Those bonds did not show any major reaction to the Fed meeting", says Reichle. He likewise does not expect any sudden end to the huge inflows of capital seen in recent months.

Instead, Reichle assumes that falling risk premiums could more than compensate for potential US interest hikes. Together with the remaining current yield, he is reckoning with potential further earnings of 1.5 to 2.0 percent. "On the whole, emerging markets government bonds in hard currency could yield a small double-digit result in 2017", according to the fund manager.

Upturn in Indonesia, Dominican Republic gradually becoming expensive

Reichle continues to be very confident about Indonesia. The country's economy has grown consistently by 5 percent per year in the past five years. A government keen on reform has succeeded in

reducing the budget deficit consistently over the same period. With the world's fourth-largest population, Indonesia has high growth potential. "All of these factors give us cause to believe that the country will move from the lower investment grade rankings toward BBB+ in the coming years", says Reichle.
Another of Reichle's longer-term favourites is the Dominican Republic. The bond market was scarcely affected by this year's hurricane season. "But the bonds have already performed very well for the risk they bear. The Dominican Republic still pays an attractive return for its BB rating. However, its weighting in the fund could taper off slightly in the future", according to Reichle.

Opportunities for returns in Africa: Ghana and Egypt catching up fast

Instead, he prefers to look at countries with a slightly weaker rating but whose business indicators show a very positive trend. For example, the Berenberg fund has a strong weighting for Ghana and Egypt. "Both of these countries have caught up hugely at a fundamental level in the more recent past", says Reichle. Ghana has cut its budget deficit to just under 7 percent in the past twelve months, with the trend set for a further reduction. Inflation dropped by 6 percent over the same period. In Egypt, currency reserves are increasing strongly, the balance of trade is constantly improving, and tourism is once again on the rise. "These countries could improve their current B rating significantly", the fund manager says.

Robust earnings expected for 2018

Looking forward to 2018, Reichle is optimistic, but points to the latent political risks. These risks will not necessarily stem from the emerging markets, but may nevertheless have a negative impact on this asset class. "But the main driver in the coming year is likely to be the continued strength of those countries' fundamentals", according to Reichle. In the past, the overall return on the Berenberg Emerging Markets Bond Selection has been 5 to 6 percent per year. "Bond investors should expect this volume of returns in the emerging markets in the long term. Earnings could even average out at this level in 2018", according to Reichle. He gauges the current yield at somewhere between 4.5 and 5.5 percent. Share price gains from a further decline in risk premiums are added to this. Because these have narrowed substantially this year already, however, there are no longer as many opportunities here. In addition, potential US interest hikes will have to be compensated.

Yet Reichle sees even fewer opportunities for other types of bonds that are linked to more risk, such as corporate bonds and high-interest bonds. "Bond valuations in the euro zone are distorted on account of the purchases by the European Central Bank. And in the USA, corporate bonds, including high-interest bonds, are already extremely expensive. In a comparison of risk-return ratios, emerging markets bonds are exceptionally attractive", concludes Robert Reichle.

Overview of the fund and its share classes:

Fund:	Berenberg Emerging Markets Bond Selection	
Tranche	Retail	Institutional
ISIN:	DE000A1C2XK8	DE000A1C2XJ0
Securities ID:	A1C2XK	A1C2XJ
Investment management company:	Universal-Investment-Gesellschaft mbH	
Depository:	State Street Bank International GmbH	
Issue date:	4 October 2010	4 October 2010
Fund manager:	Robert Reichle	
Fund currency:	EUR	
Total fund volume:	167.24 million euros	
Administration, depository and asset management compensation:	currently 1.31% p.a.	currently 0.69% p.a.

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