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ON THE RECORD

WITH COLM MCDONAGH, HEAD OF EMERGING MARKET FIXED INCOME

EMERGING MARKET (EM) ASSETS WERE BUFFETED BY WEAK COMMODITY PRICES, GLOBAL GROWTH CONCERNS, POLICY MISSTEPS AND TIGHTER FINANCIAL CONDITIONS. THESE HANGOVERS WILL LINGER IN 2016. BUT THE HIGHLY DIFFERENTIATED NATURE OF THE ASSET CLASS AND THE RANGE OF POLICY RESPONSES WILL CONTINUE TO PROVIDE OPPORTUNITIES.

SUMMARY

The class of 2015

Commodity markets were among the worst performing asset classes in 2015. The Bloomberg Commodity Index tumbled 25% in 2015, racking up its fifth consecutive yearly loss and longest losing streak since the series began in 1991. Unsurprisingly, commodity-linked currencies such as the Australian dollar, Russian rouble and Brazilian real suffered. Brazil's currency tumbled by more than 40% against the dollar in 2015, shaken by the commodities rout but also political and economic instability.

The new normal

One of the key questions for EM assets early in 2016 will be how they react to a new environment of policy normalisation in the US against a backdrop of continued commodity weakness. A number of emerging economies have deliberately shifted their economic model towards feeding the commodity super cycle over the last decade. As that super cycle has stopped turning, commodity markets and developing economies have had to bear the consequences of a painful adjustment and have attempted to smooth the transition by enacting structural and fiscal reforms or by engineering a weaker currency to ease negative terms of trade shocks. Several emerging economies have relied heavily on currency weakness to boost their flagging economies and have woefully lagged others too in terms of the pace of reforms made. We remain wary of regions such as the Middle East and sub-Saharan Africa and other significant emerging market economies where policy paralysis poses a risk, such as Eastern Europe and Latin America.

Opportunities in 2016

It could be argued that much of the bad news has already been priced in to EM valuations. The difficulty in calling a floor in 2016 is likely going to be determined by levels of liquidity and portfolio flows as they can exacerbate moves in excess of the underlying fundamental value. We have seen this occur a number of times over the past 10-15 years. We would make the argument that some valuations are looking attractive at current levels while others still have some way to go to price in the bad news. Shifting external factors could once again cloud this picture however, placing heavy emphasis on a selective and nimble investment approach that can capture the opportunities offered by a heterogeneous market.

Colm McDonagh
Head of Emerging Market
Fixed Income

FIND OUT MORE

European Business Development
europe@insightinvestment.com
+44 20 7321 1928

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

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